

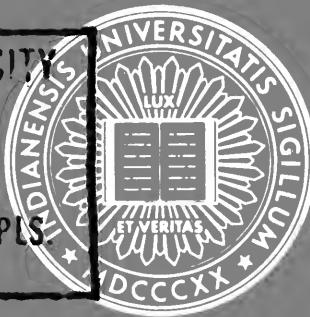
# Indiana Law Review

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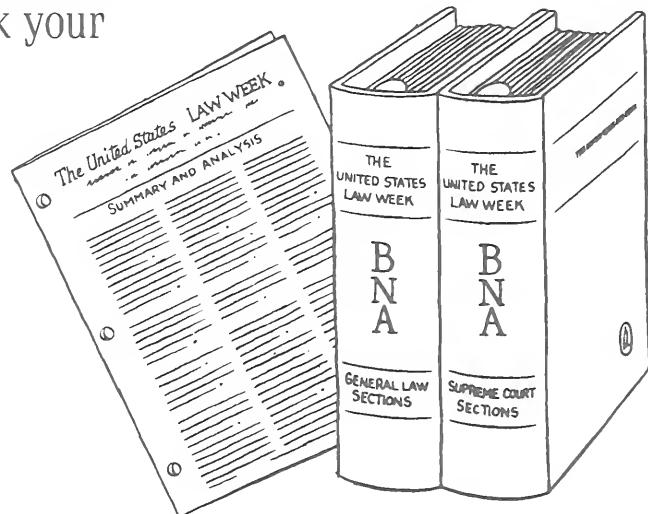
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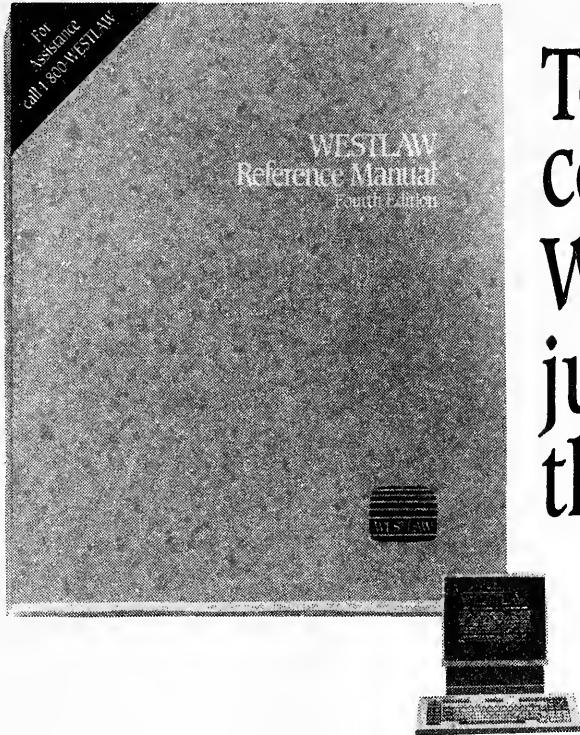
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# Indiana Law Review

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Number 2

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The entire text of this Law Review is printed on recycled paper.

INDIANA LAW REVIEW

(ISSN 0090-4198)

Published four times a year by Indiana University. Editorial and Business Offices are located at:

*Indiana Law Review*  
735 W. New York Street  
Indianapolis, IN 46202  
(317) 274-4440

**Subscriptions.** The current subscription rates are \$25.00 per four-issue volume (domestic mailing) and \$28.00 (foreign mailing). Unless the Business Office receives notice to the contrary, all subscriptions will be renewed automatically. Address changes must be received at least a month prior to publication to ensure prompt delivery and must include old and new addresses and the proper zip code.

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Volume 25

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Volume 25

1991

Number 2

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## Executive Oversight of Administrative Rulemaking: Disclosing the Impact

MARGARET GILHOOLEY\*

Executive oversight of administrative rulemaking is an omnipresent factor for regulatory agencies. The oversight process developed in the Reagan-Bush Administration (Administration) is an institutionalized process for reviewing rules that exerts a powerful supervisory influence over agency rulemaking. Operating through the Office of Management and Budget (OMB), the White House has assumed a partnership with agencies in developing policy that has replaced the role some courts assumed in the 1970s.<sup>1</sup> This expansion in the Administration's role occurred at a time when the Supreme Court increased the scope of matters left to agency discretion in the interpretation of statutes.<sup>2</sup> As a result, the Administration, through its oversight process, can influence a wide range of issues of policy and statutory interpretation. The significance of Administration oversight promises to increase in the future because of the Administration's interest in making agency guidance subject to oversight and its interest in developing policies on basic issues facing several agencies, such as risk assessment procedures.<sup>3</sup> Furthermore, the Clean

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\* Assoc. Professor of Law, Seton Hall Law School, LL.B Columbia Law School. The author worked in the Office of General Counsel of the United States Environmental Protection Agency from 1989 until early 1991. The views expressed in this Article are those of the author. I am grateful for the helpful comments on the Article received from Victor Rosenblum and Sidney Shapiro. Responsibility for the final result is, of course, my own.

1. See Verkuil, *Welcome to the Constantly Evolving Field of Administrative Law*, 42 ADMIN. L. REV. 1, 2 (1990) [hereinafter Verkuil, *Evolving Field*] (the "primary partnership" of the agencies seems to be with OMB, and the "shift to central political control under OMB is the administrative law story of the decade").

2. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843-45 (1984).

3. See *infra* text accompanying notes 40-42.

Air Act Amendments of 1990 require the issuance of numerous rules, which will bring important and disputed policy issues within the oversight process.<sup>4</sup>

Moreover, the oversight process is under scrutiny because the Administration revoked an agreement reached with some congressional leaders under which OMB would have provided reasons for changes made in the oversight process.<sup>5</sup> In addition, the President has assigned to the Council on Competitiveness, chaired by the Vice President, the task of resolving disputes between OMB and the agencies about oversight determinations.<sup>6</sup> The Council's role promises to renew the debate over whether oversight can be exercised in a way that does not displace the agency's statutory responsibility for the decision.<sup>7</sup>

The oversight process has become an established part of the regulatory scene and much has been written about it.<sup>8</sup> Additional attention is warranted because of the importance of oversight, its changing and expanding role, and the continuing debate over whether oversight unduly influences agency decisions.<sup>9</sup> This Article reexamines executive oversight

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4. See Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2399. See also *infra* text accompanying notes 45-55.

5. See *infra* text accompanying notes 119-23.

6. See *infra* text accompanying note 36.

7. See 137 CONG. REC. S16250 (daily ed. Nov. 7, 1991) (introducing S.1942, Regulatory Review Sunshine Act). See also *infra* text accompanying notes 48-55 and 189-92.

8. See, e.g., Bruff, *Presidential Management of Agency Rulemaking*, 57 GEO. WASH. L. REV. 533 (1989); DeMuth & Ginsburg, *White House Review of Agency Rulemaking*, 99 HARV. L. REV. 1075 (1986); Houck, *President X and the New (Approved) Decisionmaking*, 36 AM. U.L. REV. 535 (1987); McGarity, *Presidential Control of Regulatory Agency Decisionmaking*, 36 AM. U.L. REV. 443 (1987) [hereinafter McGarity, *Presidential Control*]; Morrison, *OMB Interference with Agency Rulemaking: The Wrong Way to Write a Regulation*, 99 HARV. L. REV. 1059 (1986); Olson, *The Quiet Shift of Power: Office of Management and Budget Supervision of Environmental Protection Agency Rulemaking under Executive Order 12,291*, 4 VA. J. NAT. RESOURCES L. 1 (1984); Rosenberg, *Beyond the Limits of Executive Power: Presidential Control of Agency Rulemaking under Executive Order 12,291*, 80 MICH. L. REV. 193 (1981) [hereinafter Rosenberg, *Beyond the Limits*]; Silverglade, *The Food and Drug Administration's Review of Regulations Pursuant to Cost-Benefit Requirements of Executive Order 12,291*, 39 FOOD DRUG COSM. L.J. 332 (1989); Strauss, *Considering Political Alternatives to "Hard Look" Review*, 1989 DUKE L.J. 538; Strauss & Sunstein, *The Role of the President and OMB in Informal Rulemaking*, 38 ADMIN. L. REV. 181 (1986); Symposium: *Presidential Intervention in Administrative Rulemaking*, 56 TUL. L. REV. 811 (1982); Verkuil, *Jawboning Administrative Agencies: Ex Parte Contacts by the White House*, 80 COLUM. L. REV. 943 (1980) [hereinafter Verkuil, *Jawboning*].

9. See, e.g., *FDA's Continuing Failure to Regulate Health Claims for Foods: Hearings Before Subcomm. on Human Resources and Intergovernmental Relations of the House Comm. on Gov't Operations*, 101st Cong., 1st Sess. 172-81 (1989) [hereinafter *Health Claims Hearings*]; NATIONAL ACADEMY OF PUBLIC ADMINISTRATION, *PRESIDENTIAL*

in light of these factors and recommends that an agency disclose, as part of the rulemaking record, when an agency has adopted an administration policy in the oversight process and the agency's reasons for doing so. Such a disclosure would promote public accountability for administration decisions and help ensure that an agency adequately exercises its statutory decisionmaking responsibility. Furthermore, disclosure would ensure that the agency has adequately considered the policy alternatives and has made a rational choice between its initial position and the position developed in the oversight process. A discussion of the alternatives is appropriate to promote reasoned agency decisionmaking and is accordingly a matter subject to judicial review.

### I. SCOPE OF THE ARTICLE

Public accountability has been offered as both a reason for and against executive oversight of regulatory agencies. Presidential supervision has been viewed as a way to make unelected bureaucrats accountable to elected political officials.<sup>10</sup> On the other hand, the lack of information about the oversight process can defeat accountability and potentially undercut judicial review of agency decisionmaking.<sup>11</sup> The concern over secrecy led to recommendations that communications between agencies and their executive branch overseers be reduced to writing and be included in the public record.<sup>12</sup> However, disclosures of this type can interfere with the deliberative process and are not necessary to ensure judicial review.<sup>13</sup>

This Article's recommendation would promote greater accountability without directly disclosing executive communications in developing policy.<sup>14</sup> Under this approach, agencies would designate, as both an administration and agency position, any policy adopted to reflect specific oral or written comments of OMB or the White House made during the regulatory review process. The designation would be made in the Federal Register preamble to the agency's proposed or final rules. In addition, the agency would identify its initial position as a policy alternative it considered and provide reasons for adopting a different

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MANAGEMENT OF RULEMAKING IN REGULATORY AGENCIES 25 (1987) [hereinafter NAPA REPORT]; McGarity, *Presidential Control*, *supra* note 8, at 457.

10. See Harter, *Executive Oversight of Rulemaking: The President is No Stranger*, 36 AM U.L. REV. 557, 568 (1987).

11. See Houck, *supra* note 8, at 552-53; McGarity, *Presidential Control*, *supra* note 8, at 456-57, 460-61.

12. See NAPA REPORT, *supra* note 9, at 35; McGarity, *Presidential Control*, *supra* note 8, at 445, 460-63.

13. Sierra Club v. Costle, 657 F.2d 298 (D.C. Cir. 1981).

14. There have been recommendations and legislative bills concerning disclosure of the facts and reasons for changes in agency positions made as a result of executive oversight. See *infra* notes 134-35 and accompanying text. This Article expands on this rationale and the legal basis for that position.

position. The content of the actual communications between an agency and OMB in developing the policy would not be disclosed.

This Article also examines whether these disclosures are a necessary part of an agency's stated basis for a rule, which is required for purposes of judicial review. In *Motor Vehicle Manufacturers Association of the United States, Inc. v. State Farm Mutual Automobile Insurance Co.*,<sup>15</sup> the Supreme Court held that an agency's revocation of a rule was inadequately supported because the agency failed to consider a previously identified regulatory alternative.<sup>16</sup> Application of the *State Farm* approach to the executive oversight process will further the goals of reasoned decisionmaking and ensure adequate attention by the agency and others to the factors warranting adoption of an administration position over the initial agency position.

The oversight process should not displace an agency's statutory responsibility to make decisions. To ensure this, an agency should be as free to disregard as to accept the positions developed in the oversight process. An obligation to disclose when an agency adopts an administration position would serve as a counterweight to the elements of the oversight process that can induce acceptance of administration positions, including the present requirement of the Executive Order that agencies disclose the reasons for *not* accepting OMB positions.<sup>17</sup>

The disclosure approach may raise concerns about intrusions into the President's ability to supervise agencies and about the consultative privacy needed to develop policy. This Article does not call for disclosure of communications during policy formation. Rather, the disclosure requirement should only apply to administration policies adopted as a result of the oversight process established under the Executive Order. Communications from the President directly to the agency would not be covered.<sup>18</sup>

A disclosure requirement imposes additional burdens. The required disclosures would indirectly affect the outcome of the consultative process to the extent that the administration is reluctant to have a policy attributed to it or an agency is reluctant to change its initial position because of the difficulty of justifying the alternative. These burdens and consequences are warranted by the benefits provided in promoting accountability and ensuring the responsible exercise of the agency's statutory role. This Article includes an analysis of these concerns and other potential objections, including the claim that disclosure needlessly probes the mind of the agency decisionmaker during rulemaking.

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15. 463 U.S. 29 (1983).

16. *Id.* at 46-51.

17. See *infra* notes 30, 176-81 and accompanying text.

18. See *infra* text accompanying notes 227-28.

The model of reasoned decisionmaking developed in the 1970s does not always mesh easily with the more recent recognition that an agency should be responsive to the policies and political direction of the administration.<sup>19</sup> The proposed disclosure does not aim to insulate agencies from politically responsive influence. On the other hand, the proposal suggests that rulemaking should be more than a response to political choices. Statutory constraints need to be respected, and the agencies need to bring their technical expertise and experience to bear. Moreover, the agencies are ultimately responsible for ensuring that the adoption of an administration position is consistent with the agency's statutory mission. Disclosure will clarify how the agency reconciles these aims. Furthermore, disclosing that an agency decision reflects an administration policy will promote accountability to the public, the hallmark of the legitimacy of political influence. Disclosure will also facilitate examination of the value of executive oversight itself. A clearer identification of administration policy provides a basis for an overall evaluation of whether the costs of executive oversight in the administrative process are justified by the benefits it provides.<sup>20</sup>

Part II of this Article reviews the basis for the executive oversight process, developments that affect its importance, and the reasons that support it. Part III discusses the principal criticisms of the oversight role, and Part IV summarizes the restrictions and disclosures presently applicable to the oversight function. Part V examines the policy reasons that support a broader disclosure requirement. The relevance of disclosure for purposes of judicial review is examined in Part VI. Finally, Part VII analyzes the legal and policy factors weighing against such a proposal and illustrates how the proposal's benefits outweigh these factors.

## II. OVERVIEW OF EXECUTIVE OVERSIGHT: ITS BASIS, PROCESS, IMPORTANCE, AND RATIONALE

### A. Basis for Executive Oversight

1. *OMB Authority Under Executive Order 12,291.*—Although Presidential oversight of agencies has a long history,<sup>21</sup> the process assumed

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19. See Verkuil, *Evolving Field*, *supra* note 1, at 2 (an increase in the OMB role places courts in a "backup role" with respect to policy outcomes). Although courts no longer assume a partnership role with respect to agency policy decisions, they overturn agency decisions based on the "hard look" standard endorsed by the Supreme Court in *State Farm*.

20. See *infra* note 143 and accompanying text.

21. See Exec. Order No. 12,044, 3 C.F.R. 152 (1978) (Carter Administration); Exec. Order No. 11,821, 3A C.F.R. 926 (1976) (Ford Administration); NAPA REPORT,

a new dimension in the 1980s. The Reagan Administration developed a more expansive and powerful review program than any preceding Administration.<sup>22</sup> The Bush Administration has continued the program. President Reagan's Executive Order 12,291 directed that "all agencies, to the extent permitted by law, shall adhere" to specified "requirements" aimed at promoting economic efficiency.<sup>23</sup> In particular, agencies are not to take action "unless the potential benefits to society for the regulation outweigh the potential costs to society."<sup>24</sup> The agency must also choose the rule with the "least net cost to society."<sup>25</sup> To ensure compliance with the Executive Order, each agency must submit major proposed and final rules and notices of non-major rules to OMB for review before issuance.<sup>26</sup> The agency must submit a regulatory impact analysis (RIA) describing the costs and benefits of the rule, any less costly alternative approaches, and the "legal reasons" for rejecting the alternatives.<sup>27</sup> The review is limited to a specified period unless OMB extends it.<sup>28</sup> There is no limit on the duration of the extension.<sup>29</sup> If the OMB Director notifies an agency of an intent to submit views on a final rule or RIA, the agency must refrain from publishing the rule until the agency has responded to and incorporated the views and its response in the "rulemaking file."<sup>30</sup> This last procedure affects agencies that plan to issue rules despite OMB concerns. Even though an agency is not required to adopt OMB views, the agency must provide a response to them.

The Executive Order expressly provides that it does not displace the responsibility of the agency head to make the decision.<sup>31</sup> When the Order was issued, the Justice Department issued an opinion that the President could direct an agency to use a cost-benefit process that the agency would not have otherwise used.<sup>32</sup> In addition, the opinion stated that,

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*supra* note 9, at 9-11; J. QUARLES, CLEANING UP AMERICA: AN INSIDER'S VIEW OF THE ENVIRONMENTAL PROTECTION AGENCY 117-421 (1976) (illustrating the EPA's quest to become the ultimate decisionmaker under the 1970 Clean Air Act, despite objections by OMB under the Nixon Administration).

22. See Exec. Order No. 12,291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988).

23. *Id.*

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.* See Bruff, *supra* note 8, at 566.

30. Exec. Order No. 12,291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988).

31. *Id.*

32. Proposed Executive Order Entitled Federal Regulation, 5 Op. Off. Legal Counsel

under the Order, an agency has "a considerable amount of decision-making discretion" and retains the "ultimate judgment" on the application of the cost benefit principles as it affects the decision.<sup>33</sup>

2. *Process of Oversight.*—The OMB review function under the Executive Order has been delegated to OMB's Office of Information and Regulatory Affairs (OIRA).<sup>34</sup> Originally, the Task Force on Regulatory Relief resolved disputes between the agency and OMB concerning the applicability of the Order.<sup>35</sup> Today, the Council on Competitiveness, headed by Vice President Quayle, performs this function.<sup>36</sup>

In practice, implementation of the Order generally involves a process of negotiation and compromise between the agency and OIRA.<sup>37</sup> In testimony before a congressional committee, OIRA characterized its role as advisory and denied that the oversight process requires clearance of agency rules by OMB.<sup>38</sup> Under the Executive Order, agencies are permitted to issue rules to which OMB has formally objected after the agency responds to OMB's objections, but the procedure has been used in only a limited number of cases.<sup>39</sup>

3. *Enhanced Importance of Executive Oversight.*—Although oversight under Executive Order 12,291 has always been important in shaping the policies of the administrative agencies, its significance continues to grow.

#### a. *OMB policy initiatives*

OMB has identified an interest in coordinating the risk assessment procedures used by many agencies. The OMB proposed policy was

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59 (1981), reprinted in *Role of OMB in Regulations: Hearings before Subcomm. on Oversight and Investigations of the House Comm. on Energy and Commerce*, 97th Cong., 1st Sess. 491-92 (1981).

33. *Id.*

34. NAPA REPORT, *supra* note 9, at 1.

35. See Exec. Order No. 12,291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988).

36. White House Press Statement (June 15, 1990) (copy on file with the Indiana Law Review). See *infra* text accompanying notes 50-55.

37. Bruff, *supra* note 8, at 559-62. For a description of the review process, see NAPA REPORT, *supra* note 9, at 26 (the "review process is more one of negotiation and accommodation than of agency initiatives being overruled by OMB demands"); Special Project, *The Impact of Cost-Benefit Analysis on Federal Administrative Law*, 42 ADMIN. L. REV. 545, 595-602 (1990) [hereinafter Special Project].

38. See *Health Claims Hearings*, *supra* note 9, at 172 (statement of James B. MacRae, Jr., Acting Administrator, OIRA) ("[W]e provide advice; we do not clear rules.").

39. See *Public Citizen Health Research Group v. Tyson*, 796 F.2d 1479, 1483 (D.C. Cir. 1986); *Health Claims Hearings*, *supra* note 6, at 493-520 (list of examples provided by OIRA); *EPA Final Rule on Small Boilers*, Environment Daily (BNA) (Sept. 5, 1990).

published in the Regulatory Program of the United States with an invitation for public comment.<sup>40</sup> OMB referred to the existing procedures which used conservative assumptions as involving "misordered priorities" and "perverse outcomes."<sup>41</sup> The development of a centralized policy on a basic and debated issue, such as risk assessment, represents an important use of the oversight role.<sup>42</sup>

OMB is also interested in developing a budget to control the aggregate costs of regulation to society.<sup>43</sup> One means of controlling regulation costs is the establishment of overall caps on the total costs of federal regulation and on programs within specific agencies. The United States Environmental Protection Agency (EPA) has agreed to use one of the programs required under the Clean Air Act as a pilot program for developing a regulatory budget.<sup>44</sup>

### b. *Clean Air Act Amendments*

The recent Clean Air Act Amendments mandate the issuance of rules under strict time deadlines.<sup>45</sup> Executive oversight has been criticized for delaying the issuance of rules.<sup>46</sup> The statutory Clean Air Act requirement for the issuance of rules under a fixed schedule means that oversight cannot simply delay a rule. Instead, its impact will be on the content of rules that are actually issued. Environmental issues proved

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40. 1990-1991 OMB REGULATORY PROGRAM OF THE UNITED STATES GOV'T 3-5, 13-26 [hereinafter 1990-91 REGULATORY PROGRAM].

41. *Id.* at 24. The OMB analysis has in turn been criticized. See *Prestigious Academic Group Calls OMB Attack on EPA Risk Methods Unbalanced*, 12 Inside EPA 5 (Jan. 25, 1991).

42. See NAPA REPORT, *supra* note 9, at 30 (concerns about centralized review).

43. 1990-91 REGULATORY PROGRAM, *supra* note 40, at 11. See Fix & Eads, *The Prospects for Regulatory Reform: The Legacy of Reagan's First Term*, 2 YALE J. ON REG. 293, 312-16 (1985) (history of the regulatory budget).

44. See *Reilly Assures White House EPA Will Toe Administration Line, Minimizing CAA Costs*, 11 Inside EPA 1, 9 (Nov. 9, 1990) (discussing the memorandum from EPA Administrator Reilly to Chairman Boskin of the White House Council of Economic Advisers).

45. Clean Air Act Amendments of 1990, Pub. L. No. 101-549, 104 Stat. 2399. For examples of mandatory rules with deadlines for issuance, see 42 U.S.C.A. § 7511b (Supp. 1991) (schedule of regulations on consumer products), 42 U.S.C.A. § 7521 (Supp. 1991) ("cold CO" carbon monoxide emission standard to be issued within one year), 42 U.S.C.A. § 7545 (Supp. 1991) (reformulated gasoline standard to be issued within one year), and 42 U.S.C.A. § 7661(a) (Supp. 1991) (permit regulation to be issued within one year). The EPA has been using regulatory negotiation for a number of important rules, and the process may indirectly affect OMB's ability to exercise regulatory review. See *Environmental Negotiators Flesh Out Bare-Bones Law*, N.Y. Times, June 24, 1991, at D1, col. 1 ("Mr. Doniger of the Natural Resources Defense Council said, 'Really, what's going on is that the Office of Management and Budget hates reg-neg, because it denies their power to come in with late hits and jerk the E.P.A. around.'").

46. See NAPA REPORT, *supra* note 9, at 37-38.

to be testing grounds for the role of executive oversight in the past, and the effort to implement the new law promises to renew disputes.<sup>47</sup>

Indeed, executive oversight has already emerged as an issue regarding a recent rule issued by the EPA under the Clean Air Act concerning Municipal Waste Combusters (MWCs).<sup>48</sup> The proposed regulation required source separation and recycling of one-quarter of the materials used in new municipal incinerators.<sup>49</sup> The source separation requirement was dropped in the final rule because of several factors, including a meeting of the Council on Competitiveness which exercised its appeal functions under the Executive Order.<sup>50</sup> The agency acknowledged in the Federal Register that part of its basis for the rule was the concern over costs and federalism raised at the Council meeting.<sup>51</sup> The Council also described its position in a "Fact Sheet."<sup>52</sup> A congressional subcommittee criticized the decision and the Council's role.<sup>53</sup> Litigation is pending on the agency rule and on whether the agency failed to exercise independent judgment in responding to the Council's views.<sup>54</sup> Congressional members have also been concerned about the impact of executive oversight on other rulemaking matters under the Clean Air Act Amendments.<sup>55</sup>

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47. See *Environmental Defense Fund v. Thomas*, 627 F. Supp. 566 (D.D.C. 1986) (environmental organization sought court order to force the EPA to promulgate regulations under the Resource Conservation and Recovery Act); Olson, *supra* note 8 (discussing the history of oversight of EPA rules).

48. EPA Standards of Performance for New Stationary Sources; Municipal Waste Combustors, 56 Fed. Reg. 5487 (1991) [hereinafter MWC Rule] (to be codified at 40 C.F.R. §§ 51, 52, 60); *EPA Proposal on Recycling is Trashed, White House Panel Opposes Agency Plan*, Wash. Post, Dec. 20, 1990, at A17. This rule was proposed before the recent amendments, but was the first major rule actually issued under the Clean Air Act as amended.

49. MWC Rule, *supra* note 48, at 5496.

50. *Id.* at 5497-98.

51. *Id.*

52. The Council's Fact Sheet reported that the Council reached a "consensus." President's Council on Competitiveness, Fact Sheet (Dec. 19, 1990) (copy on file with the Indiana Law Review). See *Quayle Council Recommends Killing Recycling Provision in Incinerator Rule*, 21 Env't Rep. (BNA) 1595 (1990).

53. Victor, *Quayle's Quiet Corp.*, Nat'l J., July 6, 1991, at 1676, 1678 (Rep. Waxman says the Council "is not accountable in any way."); *White House "Bullies" EPA Into Weakening Clean Air Act Regulations*, 21 Env't Rep. (BNA) 2124 (1991) (Rep. Waxman says OMB likes "to bully the professionals at OMB").

54. See Brief for Petitioners at 1-2, *New York v. Reilly*, No. 91-1168 (D.C. Cir., appeal docketed Apr. 10, 1991) (review of final agency rule promulgated under authority of the Clean Air Act Amendments of 1990).

55. *Democrats on House Energy Panel Attack Administration's Proposed Air Permit Rule*, 22 Env't Rep. (BNA) 8-9 (1991); *House Members Voice Concern over White House Role in CAA Implementation*, 12 Inside EPA 7 (Mar. 29, 1991) (committee members concerned about the lack of documentation in the public record on the Council's role).

c. *Applicability of oversight to agency guidance*

The Administration has interpreted the Executive Order as applying not only to substantive rules subject to notice and comment, but also to agency policy guidance to the public. The Council on Competitiveness has stated that the Executive Order applies to "all agency guidance that affects the public," including guidelines, policy manuals, and press releases.<sup>56</sup> In the past, OMB reviewed pending agency decisions of this type on a selective basis.<sup>57</sup>

d. *Oversight and Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*

The range of matters upon which courts defer to agency discretion in the interpretation of statutes has been expanded under the Supreme Court's landmark decision in *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*<sup>58</sup> In *Chevron*, the Court held that matters not clearly resolved by Congress in statutes are left to the exercise of the agency's rational discretion.<sup>59</sup> Thus, when the statute is silent or ambiguous, courts will defer to rational agency decisions.<sup>60</sup>

The oversight process has more influence over decisions in areas left to agency discretion. Agency decisions are upheld by courts under a reasonableness standard without independent judicial review of the correctness of the decision. *Chevron* clearly made agency decisions more important and indirectly increased the significance of the oversight process. Oversight can influence a greater number of agency decisions relating to statutory interpretation due to the courts' deferential test for review. The effect not only lessens the role of courts in supervising agencies, but also increases the influence of the President and the oversight process over a wider range of administrative decisions.

B. *Reasons for Presidential Oversight*

1. *Public Accountability and Presidential Supervision.*—Presidential oversight of agencies has been seen as a way to make the exercise of agency discretion subject to democratic control. Agency officials are not

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56. Memorandum from the Council on Competitiveness, Mar. 22, 1991, reprinted in Fed. Cont. Rep. (BNA) 539 (Apr. 22, 1991).

57. See 136 CONG. REC. S16970 (daily ed. Oct. 27, 1990) (Senate manager's explanation of the Clean Air Conference Report) (many EPA guidance documents on control techniques "were watered down by [OMB] review"); Olson, *supra* note 8, at 51; *EPA Balks at OMB Request to Review Major Lead Strategy for Costs, Benefits* 12 Inside EPA 3 (Jan. 18, 1991).

58. 467 U.S. 837 (1984).

59. *Id.* at 842-45.

60. *Id.* at 843.

elected, but when they are subject to policy supervision by the President, the President can be held accountable to the public for the policies. Thus, the President needs to have the ability to encourage agencies to adopt his policies.<sup>61</sup> This supervision is also part of the executive functions given to the President under the Constitution. The Constitution vests the executive power in the President<sup>62</sup> and gives the President the power to appoint officials,<sup>63</sup> obtain the opinions of heads of departments,<sup>64</sup> and to "take Care that the Laws be faithfully executed."<sup>65</sup> These constitutional powers function to ensure that the policies of government agencies are subject to supervision by an official chosen by the public.<sup>66</sup>

2. *Coordination.*—Presidential oversight is a means of addressing inconsistencies among statutes and ensuring coordination between regulatory programs. For example, Congress may pass laws that overlap, or laws may be enacted to deal with problems that fall within the responsibility of different agencies. Laws may regulate similar activities, but the laws may also be applied differently by different agencies.<sup>67</sup> As part of the coordination function, oversight may help resolve jurisdictional disputes among agencies, or it may serve as an information exchange.<sup>68</sup> Moreover, coordination may assist in developing common policies on issues that affect several agencies, such as risk assessment.<sup>69</sup>

3. *Cost-Benefit Analysis for Reviewing Rules and Regulatory Relief.*—A major feature of the Reagan-Bush regulatory review program

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61. See Harter, *supra* note 10, at 566-69; Strauss & Sunstein, *supra* note 8, at 190. For the classification and full description of the arguments supporting and criticizing the Executive Order, see McGarity, *Presidential Control*, *supra* note 8, at 446-63. See also Mashaw, *Prodelegation: Why Administrators Should Make Political Decisions*, 1 J. LAW ECON. & ORGANIZATION 81 (1985).

62. U.S. CONST. art. II, § 1, cl. 1.

63. *Id.* § 2, cl. 2.

64. *Id.* § 2, cl. 1.

65. *Id.* § 3. See Strauss, *The Place of Agencies in Government: Separation of Powers and the Fourth Branch*, 84 COLUM. L. REV. 573, 599-602 (1984).

66. See Center for Auto Safety v. Peck, 751 F.2d 1336, 1368 (D.C. Cir. 1985) ("There seems to us nothing either extraordinary or unlawful in the fact that a federal agency opens an inquiry into a matter which the President believes should be inquired into. Indeed, we had thought the system was supposed to work that way.").

67. See, e.g., Strauss & Sunstein, *supra* note 8, at 188-90; AMERICAN BAR ASS'N, COMMISSION ON LAW AND THE ECONOMY, FEDERAL REGULATION: ROADS TO REFORM (1979) [hereinafter COMMISSION ON LAW]. The ABA Commission report recommended a statute providing authority for Presidential direction of critical regulations. COMMISSION ON LAW, *supra*, at 79-84. Statutory implementation was subsequently not considered necessary for the reasons discussed in Strauss & Sunstein, *supra* note 8, at 182-83.

68. DeMuth & Ginsburg, *supra* note 8, at 1084-85.

69. See 1990-91 REGULATORY PROGRAM, *supra* note 40, at 3-5, 13-26; Reilly Assures White House EPA Will Toe Administration Line, Minimizing CAA Costs, 11 Inside EPA 1, 9 (Nov. 9, 1990).

is the obligation of agencies to use cost-benefit analysis in a systematic way.<sup>70</sup> The aim is to ensure better decisionmaking by forcing the agencies to look beyond the narrow focus of their usual bureaucratic perspective. Moreover, agencies are forced to consider the costs of their policies on the public at large, rather than solely looking at the ability to achieve a specific program goal.<sup>71</sup>

*4. Oversight and the Ability to Identify Administration Policies.*—The first two oversight rationales should not preclude identification of presidential or administration policies influencing agencies if those disclosures are otherwise considered appropriate. Policies for which the President is accountable and policies that involve coordination appear to lend themselves to formulation as identifiable policies.

The analysis approach used in executive oversight may, however, make the identification of administration policy more difficult. Under the Executive Order, the implementation of presidentially-identified policies becomes a process for analysis. This process calls for individual review of major decisions. The oversight can be in the form of requests for more information and additional analysis of the costs and benefits.<sup>72</sup> The delay and burden of developing the information can obscure whether rules are inadequate on their policy merits or for the mere lack of additional data. Agencies may delay the development or issuance of rules because of OMB's ability to ask for information that is difficult to develop. Moreover, a rule-focused process can lead to decisions about specific issues rather than the formulation of general statements of policy. The analysis approach thus may make it more difficult to separately identify administration policy. Although these factors complicate the effort to identify an administration policy, they do not eliminate the need to disclose the effect of administration policy. As discussed later, a policy should still be considered to represent both an administration and an agency policy when the initial agency policy is changed as a result of this type of oversight process, even if it is not possible to more specifically identify the administration policy.<sup>73</sup>

### III. CRITICISMS OF EXECUTIVE OVERSIGHT

Executive oversight has been the subject of criticism and debate. Many of these concerns, as discussed below, relate to the lack of information about administration policy.

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70. See *supra* text accompanying notes 23-25.

71. See DeMuth & Ginsburg, *supra* note 8, at 1082.

72. See Bruff, *supra* note 8, at 555-56, 567-68; NAPA REPORT, *supra* note 9, at 7, 37-38.

73. See *infra* text accompanying notes 241-44.

### A. Lack of Accountability

A continuing criticism of executive oversight has been the lack of administration accountability for decisions made as a result of the oversight process.<sup>74</sup> The secrecy of administration intervention prevents the public from "distinguish[ing] those policies attributable to the agencies from those attributable to the President and his aides."<sup>75</sup> Another concern is that the agency decision may be made in a particular way because of administration views, with the agency able to "manipulate" its analysis and explanation of the data "to fit a presidentially required outcome."<sup>76</sup> Moreover, executive oversight is ordinarily exercised by OMB, but OMB is not the President and is not closely supervised by him. Thus, the oversight function is not closely identified with the official who is electorally accountable.

### B. Displacement of the Agencies and Unfaithful Execution of the Laws

Executive oversight may risk a conflict with the President's constitutional responsibility to ensure that the laws are faithfully executed. The underlying concern has been that executive oversight may displace the decisionmaking vested by statute in the agency head.<sup>77</sup> Although the President may influence agency decisions, the legal responsibility for the decision remains with the agency.<sup>78</sup> The agency's ability to fulfill its responsibility is complicated, however, by the President's constitutional power to dismiss the head of an executive agency for any reason.<sup>79</sup> Moreover, OMB exercises control over the agency's initial budgetary

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74. See 132 CONG. REC. 572-73 (1986) (Statement of Sen. Levin) (OMB "acts with the iron hand, and then lets the agencies turn slowly in the wind to meet the repercussions and defend the OMB-imposed actions."); Houck, *supra* note 8, at 552-53; McGarity, *Presidential Control*, *supra* note 8, at 456-57.

75. McGarity, *Presidential Control*, *supra* note 8, at 451. See also Morrison, *supra* note 8, at 1064-67 (criticizing OMB's overruling a Cabinet officer's decisions and the resulting delay in rulemaking).

76. McGarity, *Presidential Control*, *supra* note 8, at 457. See also Olson, *supra* note 8, at 14.

77. Olson, *supra* note 8, at 15-17, 25-27; Rosenberg, *Beyond the Limits*, *supra* note 8, at 214-15.

78. See Exec. Order No. 12,291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988); Strauss & Sunstein, *supra* note 8, at 191.

79. See *Myers v. United States*, 272 U.S. 52, 135 (1926). The President's power to dismiss the heads of independent regulatory commissions is limited. See *Humphrey's Executor v. United States*, 295 U.S. 602 (1935). See also Strauss, *supra* note 65, at 609-15 (removal power over independent agencies is limited with respect to adjudicatory functions, but is less clearly limited with respect to rulemaking).

requests to Congress and has other indirect influences on the funds that are the life of an agency. In addition, the Executive Order establishes a review process that has a strong potential for influencing the agency.<sup>80</sup> Although OIRA considers its role to be advisory only, the process has been described as "more than advisory, but less than mandatory."<sup>81</sup> Congressional testimony indicates that in some instances, agency officials have perceived the process as requiring OMB approval.<sup>82</sup>

The continuing debate over the oversight process has identified some of the factors that provide safeguards against these risks. The Executive Order expressly recognizes that the agency decision is not to be displaced.<sup>83</sup> The recognition of the agency as the primary decisionmaker should have a restraining effect on the supervisory process.<sup>84</sup> Mere knowledge by the agency that the administration supports a particular position is not considered sufficient to displace the agency's judgment.<sup>85</sup>

In practice, the President's ability to dismiss an agency head also has practical limits. A dismissal is likely to lead to public visibility of the reasons for dismissal and congressional attention to the issue during the appointment of a successor. Thus, the agency head has some ability to resist executive influence and to threaten resignation in a dispute.<sup>86</sup> Nonetheless, concerns remain regarding the ability of executive oversight to influence the agency's decision.<sup>87</sup>

The constitutionality of Executive Order 12,291 has also been questioned because of its scope and its potential to displace the agency's

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80. Bruff, *supra* note 8, at 559-68.

81. Compare *Health Claims Hearing*, *supra* note 9 (OIRA testimony) with NAPA REPORT, *supra* note 9, at 26 (Although OMB views its role as purely advisory, the National Academy of Public Administration concluded in its 1987 report that the review process is more than advisory, but less than mandatory).

82. *Health Claims Hearing*, *supra* note 9, at 121 (testimony of Dr. Frank Young, Comm'r of the Food and Drug Administration) ("If OMB does not concur, I do not believe those rules can be published. We have to get an approval to publish a regulation"). See also *id.* at 177 (statement of Rep. Ted Weiss) (FDA perceives OMB's role as more conclusory and determinative than OMB views it to be); Olson, *supra* note 8, at 43-50.

83. Exec. Order No. 12, 291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988).

84. Strauss & Sunstein, *supra* note 8, at 191.

85. See *Center for Auto Safety v. Deck*, 751 F.2d 1336, 1369 (D.C. Cir. 1985) ("It is entirely absurd to suggest that a delegated decision is vitiated by the mere knowledge that the superior would have preferred it to come out the way it did"); Davis, *Presidential Control of Rulemaking*, 56 TUL. L. REV. 849, 857 (1982) ("That individuals within the agency conform to the preference expressed by the President or his representative rather than risking removal from office does not change the solid fact that if any change is made in the agency's rule the change is made by the agency.").

86. Strauss, *supra* note 65, at 590.

87. For recent Congressional criticisms of OMB's role, see *supra* notes 7, 55.

judgment.<sup>88</sup> The concept of a “unitary executive” making decisions is viewed as inconsistent with the statutory responsibility of the agency, a responsibility the President is constitutionally bound to respect. In *Chevron*, the Supreme Court recognized that it is appropriate for the incumbent administration to influence an agency,<sup>89</sup> but courts have not directly resolved the constitutionality of the Order.<sup>90</sup>

### C. Inconsistency with Judicial Review

Commentators have also viewed presidential oversight as potentially impeding judicial review of agency action for conformance to the statute and lack of arbitrariness.<sup>91</sup> A particular concern has been that the agency will make its decision a particular way because of executive oversight, but no record will exist of the true grounds upon which the decision is based, and the decision may be upheld on other grounds.<sup>92</sup>

In *Sierra Club v. Costle*,<sup>93</sup> however, the court stated that face-to-face presidential communications to the agency are not a necessary part of the agency record for review purposes.<sup>94</sup> The President has constitutional authority to exercise “control and supervision” over executive agencies and can invoke executive privilege to protect “consultative privacy.”<sup>95</sup> Disclosing presidential communications would disrupt the deliberative process. Moreover, disclosure is not necessary to ensure a rational decision. A rule issued by an agency must have factual support

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88. See Rosenberg, *Beyond the Limits*, *supra* note 8; Rosenberg, *Presidential Control of Agency Rulemaking: An Analysis of the Constitutional Issues That May Be Raised by Executive Order 12,291*, 23 ARIZ. L. REV. 1199 (1981). See also Bowers, *Establishing the Constitutional Legitimacy of OMB’s Regulatory Review: A Shared Powers Perspective*, 25 NEW ENG. L. REV. 397 (1990) (executive review, like legislative veto, should require a written statement and an opportunity for Congress to override). But see Shane, *Presidential Regulatory Oversight and the Separation of Powers: The Constitutionality of Executive Order 12,291*, 23 ARIZ. L. REV. 1235 (1981).

89. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 865 (1984).

90. See *Public Citizen Health Research Group v. Tyson*, 796 F.2d 1479, 1507 (D.C. Cir. 1986) (“difficult” constitutional questions were not addressed because of other grounds for invalidating the decision); *Environmental Defense Fund v. Thomas*, 627 F. Supp. 566, 570 (D.D.C. 1986) (improper use of executive order to withhold approval of rules until agency accepted OMB changes would encroach on agency’s statutory role).

91. McGarity, *Presidential Control*, *supra* note 8, at 460-61.

92. See Olson, *supra* note 8, at 32.

93. 657 F.2d 298 (D.C. Cir. 1981).

94. *Id.* at 407. In certain instances, the court recognized that docketing of oral presidential communications may be necessary, such as where a statute “specifically requires that essential ‘information or data’ upon which a rule is based be docketed.” *Id.* (emphasis in original).

95. *Id.* at 405.

in the record, and under the particular statute, the rule may not be based on information or data not in the record.<sup>96</sup> The court recognized the risk that the President could direct an outcome that is factually based in the record, but that is different from the one that would have occurred absent presidential influence.<sup>97</sup> The possibility of such a political impact is one that "the courts could not police."<sup>98</sup> Congress did not intend for courts to make rulemaking a process unaffected by presidential power.<sup>99</sup> Although the communications in *Sierra Club* concerned a single direct presidential discussion, oral communications are not made a matter of record in the more expansive oversight program established under Executive Order 12,291.<sup>100</sup> Recommendations continue to be made that communications made during oversight be summarized for the record, but these recommendations have not been adopted.<sup>101</sup>

#### IV. LIMITATIONS ON EXECUTIVE OVERSIGHT AND EXTENT OF DISCLOSURE

Notwithstanding criticism, executive oversight has survived and grown in importance. OMB has adopted some restrictions in response to the criticisms and the recommendations of the Administrative Conference. In addition, Congress considered measures to ensure additional disclosure of the impact of oversight and to limit OMB's influence in other respects. The measures adopted by OMB deal with conduit communications from private parties and provide for the disclosure of draft rules and other limited information about administration positions.

##### A. *Conduit Communications*

One risk of executive oversight is that a private party may communicate concerns to OMB which will be reflected in OMB's comments to an agency, but will not appear in the agency record. Failure to include outside views in the agency record precludes an opportunity to respond for the record. Moreover, the administrative record used to support the rule for judicial review will not reflect the positions of those outside the government that influenced the decision. These conduit comments from outsiders may assume "special prominence in the agency's review" due to their endorsement by OMB.<sup>102</sup>

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96. *Id.* at 407 n.529.

97. *Id.* at 408.

98. *Id.*

99. *Id.*

100. See Olson, *supra* note 8, at 35 n.162.

101. See McGarity, *Presidential Control*, *supra* note 8, at 445, 461-63; NAPA REPORT, *supra* note 9, at 35.

102. Bruff, *supra* note 8, at 579.

OMB has, as a matter of policy, adopted procedures to disclose written communications in all proceedings and to list oral communications in the rulemakings of EPA and other agencies upon request.<sup>103</sup> Under the procedures, the written communications are available in the OIRA reading room, and OIRA advises the public to send comments to the agency as well as to OIRA.<sup>104</sup> OMB also invites EPA and other agencies requesting the procedure to all scheduled meetings with outsiders and sends these agencies copies of written communications.<sup>105</sup> OMB may still communicate orally with outside parties, but these communications are made with the approval of the OIRA director and in the case of EPA and requesting agencies, the agency must be informed.<sup>106</sup>

The conduit restrictions represent one means of establishing limits on executive oversight by providing a limited paper record of the input from the public. The written communications and list of the oral communications are available at OIRA. Those who examine the OIRA records can consider the effect of the communications for themselves. The disclosures for this purpose do not, however, directly identify OMB policies.

#### *B. Disclosure of Written OIRA Communications*

In addition to conduit communications from outsiders, executive communications are also subject to voluntary OIRA disclosure provisions, but these are more limited in scope. OIRA adopted a procedure of disclosing written correspondence exchanged between OIRA and the agency head.<sup>107</sup> OIRA procedures provide in "general" for written reasons to the agency when a rule is returned to the agency for inconsistency with the President's program.<sup>108</sup>

These restrictions provide only a limited basis for discovering administration policy. Written communications are included in the record, but only when they are from the head of OIRA. Communications from staff are not covered. Furthermore, oral communications are not part of the record even though they can be important in negotiating a rule

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103. Memorandum from Wendy L. Gramm, Adm'r OIRA, to Agency Heads (June 13, 1986, rev. Aug. 8, 1986), *reprinted in 1990-91 REGULATORY PROGRAM, supra* note 40, at 605 [hereinafter Gramm Memorandum].

104. *Id.* at 605-06.

105. *Id.* at 606.

106. Memorandum from Robert P. Bedell, Deputy Adm'r OIRA, to OIRA staff (May 30, 1985) (discussing OIRA policies), *reprinted in 1988-1989 OMB REGULATORY PROGRAM OF THE UNITED STATES Gov't* 537 (as Attachment D to Gramm Memorandum, *supra* note 103).

107. Gramm Memorandum, *supra* note 103, at 530.

108. *Id.* at 529-30.

between OMB and an agency.<sup>109</sup> Rule changes are more likely to occur as a result of the oral negotiation process. In its recent review of OMB procedures, however, the Administrative Conference of the United States did not recommend the summary of oral communications for the record because of the adverse impact on free discussion, negotiation, and compromise that are aspects of developing policy during the oversight process.<sup>110</sup>

### C. Disclosure of Agency Draft Rules Submitted for Review

Since 1977, the Clean Air Act has mandated that EPA drafts and interagency communications relating to oversight be made publicly available upon publication of the proposed or final rule.<sup>111</sup> Agency draft revisions responding to OMB comments are also included in the agency docket. The disclosures are made only after the proposed or final rule is published, thus averting last-minute interventions or lobbying by outside parties.<sup>112</sup> Although the Act requires that the drafts be available in the public docket, it does not require that drafts be part of the administrative record for judicial review. According to the *Sierra Club* court, the exclusion occurred because Congress presumably recognized that the court was "not to concern itself with who in the Executive Branch advised whom about which policies to pursue."<sup>113</sup>

As a matter of policy, OMB now provides for the disclosure of drafts submitted to OMB by an agency after a proposed or final rule is published upon a written request to OIRA for the draft.<sup>114</sup> The agencies do not, however, necessarily make the drafts available in their rulemaking record. Drafts are not available, for example, in the agency rulemaking docket at the Food and Drug Administration.<sup>115</sup> The Administrative Conference has also recommended disclosures of agency drafts, including drafts submitted to OMB when no rule is proposed.<sup>116</sup> These steps create a paper trail that allows some monitoring of the effect of executive

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109. See NAPA REPORT, *supra* note 9, at 35; Bruff, *supra* note 8, at 583 (discussion of "gaps" in OIRA procedures).

110. See Recommendations of the Admin. Conference of the United States, 54 Fed. Reg. 5207, 5208 (1989) (to be codified at 1 C.F.R. § 305.88-9); Bruff, *supra* note 8, at 588. But see NAPA REPORT, *supra* note 9, at 35 (recommending disclosure of oral communications).

111. 42 U.S.C. § 7607(d)(4) (1988). See also The Clean Air Act Amendments of 1977, P.L. No. 95-95, 91 Stat. 685.

112. See Bruff, *supra* note 8, at 585.

113. *Sierra Club v. Costle*, 657 F.2d 298, 405 n.519 (D.C. Cir. 1981).

114. Gramm Memorandum, *supra* note 103, at 605, 606.

115. Telephone interview with Linda Horton, Assoc. Chief Counsel for Regulations and Hearings, Food and Drug Admin. (Oct. 9, 1991).

116. 1 C.F.R. § 305.88-9, para. 4 (1991).

oversight without the need to disclose particular communications within the Executive Branch.

The disclosure of proposed drafts and final rules transmitted by the agency to OMB provides valuable indirect disclosure about the impact of OMB's review. The effect of the disclosure of the drafts is generally to make OMB changes detectable to the diligent who compare the version sent to the version adopted. By focusing on separate revisions and insertions made by the agency to the initial draft, one may detect the changes made as a result of OMB discussions. Still, additional effort is required to compare the versions, which may be lengthy, and to decipher whether the changes reflect OMB views. Effort is also needed to obtain the drafts from OIRA and the agency record, if available. There is no disclosure in the Federal Register to alert the public to these differences. Moreover, because of timing difficulties and statutory deadlines, the agency may send its draft to OMB for concurrent review while agency review is still being completed. This practice of concurrent review by OMB and the agency hinders identification of OMB's involvement in the final decision because one may be unable to determine whether changes were made in response to OMB views or were modifications made at the agency's own initiative.<sup>117</sup> This step is, then, only an indirect and time-consuming way of discovering the impact of OMB decisions on agency rules. Moreover, although the drafts may be disclosed by OIRA, they may not be part of the agency record for purposes of judicial review.<sup>118</sup>

On a policy basis, these disclosures are useful as a safeguard for ensuring that the process reflects the appropriate standards and for permitting better public and congressional understanding of the basis of OMB's positions. The utility of these procedures will be examined later, but at this point, their value and limits must be recognized in promoting accountability.

#### *D. Retraction of OMB-Congressional Agreement for OMB Disclosure of Reasons*

At one point, as a result of congressional pressure, OMB agreed in principle to provide "a detailed written explanation of the specific reasons for all substantive changes" made to a proposed or final rule when a review "is concluded with substantive changes made by the agency as

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117. See Olson, *supra* note 8, at 46-47 (EPA involves OMB in the development of some rules even before drafts are formally submitted to OMB).

118. For a discussion of whether review could be excluded depending on the issues concerning executive privilege, see *infra* notes 213-20 and accompanying text.

a result of the review process" or as a result of a suspension of review or return of the rule to the agency.<sup>119</sup> The explanation was to be included in the OIRA public docket.<sup>120</sup> The agency was also to have the opportunity to supplement the agency public docket to give a written explanation of the agency's reasons for making the changes in response to any oral or written OIRA comment on a proposed draft or final rule.<sup>121</sup> Substantive changes included "suggested changes to or criticisms of" the agency proposal.<sup>122</sup> However, the agreement was retracted by the Administration in 1990 because it "would fundamentally impede the president's conduct of his constitutional responsibility."<sup>123</sup>

Although there are important similarities between the disclosure obligation provided for in the revoked agreement and that recommended in this Article, the disclosure obligation under the agreement would have been more limited. The disclosure would have been made by OIRA, and the agency would have had the option, but not an obligation, to provide an explanation of the changes in the agency docket. The Federal Register notice accompanying the rule would not require disclosure of the reason for the changes. Disclosures made solely in the OIRA docket would have been less accessible to the public. Most importantly, the significance of the disclosures for purposes of judicial review would not have been clear.

#### *E. OMB Disclosures in the Regulatory Program of the United States*

On occasion, OMB has included general information about its oversight of agency rules in the introductory sections of the annual Regulatory Program. This annual book lists forthcoming rules that are part of the annual regulatory agenda.<sup>124</sup> This summary indicates that OMB review found only seventy-four percent of the agency rules consistent without changes in 1989, as compared with eighty-seven percent in 1981.<sup>125</sup> The 1987-1988 Regulatory Program provided nine case studies of rules that were improved because of OMB oversight, but it provided little infor-

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119. 135 CONG. REC. E3925 (daily ed. Nov. 17, 1989) [hereinafter Administrative Agreement] (Administrative Agreement Outlining Procedures Governing OIRA Review of Regulations Under Executive Order Nos. 12291 and 12498).

120. *Id.* See also Olson, *supra* note 8, at 64-67.

121. Administrative Agreement, *supra* note 119, at E3926.

122. *Id.*

123. *Conyers Asks to Eliminate OIRA Fundings*, 21 Env't Rep. (BNA) 334 (June 15, 1990).

124. The preparation of a yearly regulatory agenda is provided for under Exec. Order No. 12,498, 50 Fed. Reg. 1036 (1985).

125. See 1990-91 REGULATORY PROGRAM, *supra* note 40, at 646.

mation about the specific nature of the changes made in the other rules.<sup>126</sup>

#### *F. Statutory Requirements and Deadlines*

Executive oversight is permissible only within the scope of the discretion delegated to an agency.<sup>127</sup> OMB may not influence an agency to violate statutory provisions, including time limits for action established by law.<sup>128</sup> One court specifically found that OMB may not direct an agency to delay the issuance of a rule to permit review under the Executive Order when the review period would extend beyond the statutory deadline.<sup>129</sup> Thus, the establishment of specific statutory deadlines and requirements provides a means to limit OMB's ability to influence agencies.

Recent congressional enactments include a number of mandatory requirements and fixed deadlines governing rules that curtail the scope of agency discretion.<sup>130</sup> The recently enacted Clean Air Act Amendments are replete with specific requirements and time deadlines, many of them remarkably short.<sup>131</sup> In part, these restrictions reflect an effort by Congress to limit OMB's ability to affect agency decisions.<sup>132</sup> Consequently, as executive oversight has increased, the willingness of Congress to rely on administrative discretion has suffered some decline.

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126. 1987-1988 OMB REGULATORY PROGRAM OF THE UNITED STATES xv-xxii. *See also* DeMuth & Ginsburg, *supra* note 8, at 1082-85 (additional examples of the effect of oversight).

127. *See Dole v. United Steelworkers*, 494 U.S. 26 (1990) (invalidating agency action based on an incorrect OMB interpretation of the Paperwork Reduction Act); Exec. Order No. 12,291, 3 C.F.R. 127 (1981), *reprinted in* 5 U.S.C. § 601 note at 473-76 (1988) (recognizing that review is permissible only to the extent permitted by law).

128. Exec. Order No. 12,291, 3 C.F.R. 127 (1981), *reprinted in* 5 U.S.C. § 601 note at 473-76 (1988).

129. *Environmental Defense Fund v. Thomas*, 627 F. Supp. 566, 571 (D.D.C. 1986) (OMB review may not delay promulgation of rule beyond statutory deadline). *See also* *Public Citizen Health Research Group v. Commissioner*, 724 F. Supp. 1013 (D.D.C. 1989) (unnecessary reproposal constituted unreasonable delay, with agency and OMB enjoined to issue rule); *Special Project*, *supra* note 37, at 601-02 (limited situations in which OMB may exercise review power).

130. *See, e.g.*, Resource Conservation and Recovery Act, 42 U.S.C. § 6924(c)(2) (1988) ("administrator shall promulgate final regulations" within 15 months). *See also* Shapiro & Glicksman, *Congress, The Supreme Court, and the Quiet Revolution in Administrative Law*, 1988 DUKE L.J. 819, 825-28 (suggesting that specific statutory requirements were enacted as a response to agency inaction and to agency actions inconsistent with the statute).

131. Pub. L. No. 101-549, 104 Stat. 2399 (1990).

132. *See Enforcing the New Clean Air Rules*, Wash. Post, Nov. 19, 1990, at A13, col. 1.

The imposition of deadlines and the restriction of agency discretion has its own drawbacks.<sup>133</sup> The deadlines may prove to be unrealistic. Because Congress cannot always anticipate the factors affecting policy decisions, the statutory restrictions may have undesired effects. In addition, the statutory provisions may even provide more agency discretion when interpreted in the light of *Chevron* than Congress might have expected in enacting the seemingly mandatory requirements. Still, the enactment of statutory requirements and deadlines is an important, but problematic, means available to Congress to limit executive oversight.

#### *G. Agency Disclosure of Reasons for Changing Position*

Agency disclosure of the reasons for changes from the agency's initial position as a result of executive oversight has received some support. Commentators have recommended that the Executive Order be amended to require disclosure.<sup>134</sup> In addition, congressional bills have proposed requiring agencies to establish a public file disclosing OMB intervention and the reason for changes in the agency rule.<sup>135</sup> This Article expands on the policy and legal rationale for adopting such an obligation and for making the disclosure a matter relevant for purposes of judicial review.

### V. DISCLOSURE OF ADMINISTRATION POLICY: POLICY SUPPORT

#### *A. Nature of Recommendation*

This Article recommends a broader disclosure requirement than those discussed previously. Each agency should be responsible for disclosing in the preamble of a proposed or final rule any portions of a rule that have been revised to reflect administration policy as a result of the

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133. Shapiro & Glicksman, *supra* note 130, at 844.

134. Davis, *supra* note 85, at 857. See Cutler, *The Case for Presidential Intervention in Regulatory Rulermaking by the Executive Branch*, 56 TUL. L. REV. 830, 847-48 (1982) (supporting disclosure requirement preferably through a statutory change).

135. 137 CONG. REC. S16250 (daily ed. Nov. 7, 1991) (Regulatory Review Sunshine Act); 132 CONG. REC. 572, 574 (1986) (S.2023 proposing establishment of file); *Id.* at 578 (statement of Senator Levin) (S.2023 aids in accountability because by "requiring the extent of OMB's involvement to be in the public record, OMB will itself be responsible for its own actions and will not be able to hide behind the agency and escape public scrutiny"). For an earlier example, see 128 CONG. REC. 5285-305 (1982) (S. 1080, the Regulatory Reform Act of 1982, passed the Senate as amended); 128 CONG. REC. 25662-63 (1982) (statement of Rep. John D. Dingell criticizing the Senate reform bill). Further background is provided in *Oversight of OMB Regulatory Review and Planning Process: Hearings before the Subcomm. on Intergovernmental Relations of the Senate Comm. on Gov't Affairs*, 99th Cong., 2d Sess. 56, 98 (1986) (statements of Senators Levin and Durenberger regarding proposed act requiring disclosure of OMB involvement).

oversight process and the reasons for the change. The disclosure should apply when an agency adopts a policy as a result of oral or written communications with any officials involved in the executive oversight process, whether the officials are in the OIRA, the OMB, the Council on Competitiveness, or the White House. The disclosures, however, should not apply to direct communications from the President to the agency unless they are based on the oversight process under the Executive Order. A policy should be deemed an administration policy when the agency adopts a position in response to comments from the OIRA staff. In addition, the disclosure should apply to a joint agency-administration policy developed through informal negotiations aimed at clearance of the rule. Disclosure would be needed only for substantive changes, but would not extend to insignificant changes that correct errors.

The disclosure should identify the agency's initial policy and the reasons for adopting a different policy position as a result of the oversight process. The disclosure of the administration's contribution in developing the policy could take the form of an indication that the final position was developed in consultation with the administration by a designation of the policy as both an administration and agency policy or in some other manner that reflects the administration's contribution to the development of the specific position. Instead of being designated as an administration policy, the policy could be described as OMB or OIRA policy.

The disclosure should apply to administration policies adopted at any stage of the rulemaking process. Thus, the disclosure is appropriate for a proposed as well as a final rule. When an administration position affects the agency's response to comments in the final rule, the agency should indicate its initial policy response to the comment and the role of administration policy in reaching the ultimate result. In addition, when OMB is involved in the initial development of an agency proposed rule prior to submission for formal review, the agency should disclose any specific positions that were developed in conjunction with the administration.<sup>136</sup>

This recommendation has two parts. The first is an obligation to discuss the policy alternative initially considered by the agency, along with the reasons for the policy adopted. The second is a designation that the policy adopted reflects an administration as well as an agency policy. The first obligation is especially important in ensuring that the basis for the decision is fully disclosed, and the second is important for

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136. See Olson, *supra* note 8, at 46-47 (examples of OMB involvement at preproposal stage and effectiveness of this means of exerting influence).

ensuring accountability. Even though the two parts are interrelated, each may be separated and individually adopted.

### B. Policy Reasons for Recommendation

1. *Public Accountability for Administration Policy.*—Disclosure of administration policy leads to greater public accountability for the oversight role in the process of policy development. Executive oversight increases the President's ability to influence agencies and promotes accountability of the agencies through the electoral process. If the administration's contribution to policy development through the oversight process is not disclosed, no corresponding accountability exists for the administration's role in influencing the agency's decisions.<sup>137</sup>

Critics of executive oversight are concerned that an agency decision influenced by undisclosed executive oversight will be justified by other factors upon judicial review.<sup>138</sup> The secrecy of the communications has especially prompted such a concern. Under this recommendation, communications between the agency and OMB would remain confidential in order to allow free discussion and "consultative privacy" in formulating policy. The agency would, however, have to acknowledge the administration's contribution to the decision adopted. The disclosure avoids the suspicions that otherwise arise when the administration's influence is not acknowledged.<sup>139</sup>

Disclosing a policy as an administration position may be considered unnecessary to ensure accountability because the President is responsible for all activities of agencies. The President also appoints the agency head. Moreover, all agency rules may be deemed to represent an administration position by virtue of having passed through the Executive Order oversight process, either with or without change.<sup>140</sup> The review process itself may be thought to ensure accountability for administration policies without the need for specific disclosures.

The argument, however, does not recognize the additional need for accountability for the specific effect oversight has on agency decisions. The administration itself has not considered the appointment process or the general provisions of the Executive Order sufficient to ensure the accountability of agencies absent the additional contribution provided by the oversight process.

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137. McGarity, *Presidential Control*, *supra* note 8, at 456-57. See also Houck, *supra* note 8, at 555-56 (proposing a presidential veto over agency rule as a better means of identifying the Administration's involvement).

138. See *supra* notes 91-101 and accompanying text.

139. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 865 (1984).

140. See Harter, *supra* note 10, at 568.

The oversight process has a distinct power to influence agencies, and disclosure is needed to reflect the specific contribution of the administration in the oversight process. Moreover, when the agency and OMB differ on policy issues, difficulties exist in applying the administration's principles in the particular setting. In this context, the public identification of an administration policy will illuminate the administration's contribution on the more difficult and significant policy issues.

Under this proposal, the disclosure reflecting the administration's role in developing policy would be in the preamble to the rule or proposal. Placement in the preamble makes the impact of administration positions more readily discernible to the public than other disclosure measures, such as the docketing of agency drafts for the record. A disclosure in the preamble indicates when an administration policy actually has an impact on a particular decision. This type of disclosure provides for a more informed public understanding of administration policy.

2. *Policy-Directed Oversight.*—Another reason for recommending that administration policy be designated in agency rules is to encourage oversight that identifies general policy positions, rather than oversight that simply reviews and second-guesses agencies in the implementation of policies in a particular statutory setting. The recent Reagan-Bush forms of executive oversight are largely concerned with the application of cost-benefit principles to the rulemaking process. Only to a limited degree has the oversight process resulted in statements of broader policy principles.<sup>141</sup>

Part of the supporting rationale for oversight is coordination of agency policies in areas of overlap.<sup>142</sup> These broader policy objectives are aided by the public identification of general policies. Indeed, oversight that aims to make agencies take account of considerations beyond their narrow bureaucratic concerns should be facilitated by a continuing effort to state the effect of the broader policy concerns as the policy impacts the specific issues. Agencies have been urged to articulate their general policies because it provides for accountability and better direction.<sup>143</sup>

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141. For OMB efforts to state its policies for comment in its annual Regulatory Program, see *supra* notes 40-41. The articulation of general policies, although preferable to ad hoc review, increases the importance of public comment and review of the policies OMB seeks to have the agencies adopt. See also NAPA REPORT, *supra* note 9, at 30.

142. See Strauss & Sunstein, *supra* note 8, at 193 (criticizing oversight that intervenes in general run of cases, but supporting oversight in cases needing coordination or involving important issues).

143. Administrative Conference of United States, Recommendation 71-3, 1 C.F.R. § 301.71-3 (1991); H. FRIENDLY, THE FEDERAL AGENCIES: THE NEED FOR BETTER DEFINITION OF STANDARDS (1962).

This principle applies equally to executive oversight. Oversight focused on particular rules can suffer from some of the defects it is intended to counteract. Oversight that fails to identify general policies can elude accountability.

Oversight of the analysis type may not lend itself to the statement of specific administration policies because the review may reflect a different evaluation of the balance of competing considerations. If a specific administration policy cannot be stated, the impact of the review process should be indicated by disclosing that the final policy was developed by the agency in conjunction with the administration. The oversight process should be accountable for the contribution it makes even if it is only an analysis-review function.

Oversight of the analysis-review type may be necessary to counteract staff capture.<sup>144</sup> After an agency head is presented with a final package, the official may be reluctant to make changes because of the substantial amount of time invested by the agency.<sup>145</sup> The need to prevent staff capture does not eliminate the appropriateness of disclosing administration policy. Indeed, the disclosure will ensure that the agency head gives adequate attention to the staff's position on the policy issues. Agency heads get "captured" by their staffs largely because of the need to deal continually with the restraints on the agency's powers. The staff's influence grows out of its expertise with the technical issues, a continuing experience with the history of the issues, an effort to develop a sustainable, somewhat consistent policy over time, and the need to make legally defensible decisions.<sup>146</sup> In making decisions, the agency head also needs to be aware of the concerns of public interest groups, regulated industries, and congressional oversight committees. The agency head may be captured, not by the staff, but by an awareness of the wider views of the agency's mission. The oversight process has drawbacks as a solution to staff capture unless careful consideration is given to the reasons why agency policy, as formed by administration concerns, warrants a different result from the one the agency and its staff initially recommended.

Executive oversight that is isolated from the process and from public accountability does not have the agency's perspective and the type of perspective generally needed to make ultimate decisions. Requiring an agency to state reasons why it departed from its initial views ensures that careful attention will be devoted to the agency's initial policy issues by those involved in oversight, including the agency head.

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144. See Harter, *supra* note 10, at 568-69; Strauss & Sunstein, *supra* note 8, at 187.

145. Harter, *supra* note 10, at 568.

146. See Freedman, *Expertise and the Administrative Process*, 28 ADMIN. L. REV. 363 (1976); Jaffe, *The Effective Limits of the Administrative Process: A Reevaluation*, 67 HARV. L. REV. 1105, 1132-33 (1954).

Currently, executive oversight undertakes a silent role in affecting the agency policy without providing accountability for the decisions made. The need, though, is to have policy that is publicly articulated at the agency level. Appointing agency officials who can identify administration policy as it reflects the agency's mission is a preferable means of influencing agency decisions. If oversight is used instead to prompt the adoption of administration policy in the context of reviewing particular rules, then a disclosure policy will be beneficial in directing the process towards adequately considering the issues in light of the agency's mission and in providing better identification of the administration's policy.

Executive oversight imposes costs on the process in terms of delay and the personnel resources involved. By disclosing when oversight has led to the adoption of an administration policy, there is a basis for knowing the contribution that oversight is making with respect to policy formulation. That contribution can be evaluated in relationship to the costs it imposes.<sup>147</sup>

*3. Policy Safeguard to Ensure Faithful Execution of the Law and Agency Responsibility for the Decision.*—The separate identification of administration policy can provide an additional safeguard, on a policy basis, that executive oversight reflects the appropriate statutory considerations and does not displace the agency's primary responsibility for interpreting and applying the statute. The general safeguards currently preventing undue influence rely on the self-restraint of the agency and the executive to recognize the statutory assignment of responsibility, the prospect for highlighting the dispute if the agency head resigns or is dismissed for issuing a rule contrary to the views expressed during the oversight process, and the availability of judicial review of the support for the actual decision.<sup>148</sup>

The constraint provided by the possibility of resignation and dismissal relies on a type of brinkmanship to ensure an adequate agency role. An obligation to disclose the impact of administration policy when changing an initial agency position in the rule would provide a more regular and routine means of ensuring that full weight is given to the agency position. Furthermore, the administration and the agency bring different perspectives to the resolution of public issues — one is a concern about the wider public interests and the costs to the economy,

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147. For the limited information available from OMB relating to the impact of oversight, see *supra* notes 124-26 and accompanying text. See also McGarity, *Regulatory Analysis and Regulatory Reform*, 65 TEX. L. REV. 1243 (1987) [hereinafter McGarity, *Regulatory Analysis*] (discusses advantages and disadvantages of regulatory analysis in bureaucratic decisionmaking).

148. See *supra* notes 83, 96 and accompanying text.

and the other is the specific problem focus that underlies the statute. Decisions shaped by executive oversight warrant more attention because of the risk that oversight may relate to wider public interest factors, not explicit in the statute, that may be beyond those that the statute permits.<sup>149</sup> A disclosure in a rule that a policy represents an administration policy permits additional examination of whether the wider public interest concerns were appropriately considered with respect to the particular issue under the statute.

The degree of agency discretion under the statute may often complicate the determination of whether the wider administration position is reasonable and appropriate. Whether the statute is being faithfully executed may be a question without a clear answer. This very uncertainty about the appropriate standard and the scope of discretion within which oversight can play a role supports the need for disclosure on policy grounds. Disclosure also provides added assurance that the agency position has been considered and that the agency has exercised its judgment in determining the relevant factors in a setting in which the appropriate factors may be debatable. These considerations support the adoption of a disclosure obligation by statute or as a matter of policy.

## VI. DISCLOSURE AS AN ELEMENT OF A BASIS OF DECISION FOR JUDICIAL REVIEW

Disclosure of the impact of oversight on agency decisions has not been considered necessary for judicial review. Instead, the fact that a rule needs rational support in the agency record is generally seen as sufficient to ensure its rationality for purposes of judicial review.<sup>150</sup> The content of the decision is considered to be important for review, rather than the identification of who advised the agency in reaching the decision.<sup>151</sup> The analysis below points to the insufficiency of solely examining the rationality of the adopted decision to ensure that the record reflects the factors an agency should consider in reaching a rational decision when the agency has changed its position as a result of executive oversight. Furthermore, it is important, under the law, that the agency make the

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149. See Exec. Order No. 12,291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988); Olson, *supra* note 8, at 51-53; Sunstein, *Cost-Benefit Analysis and the Separation of Powers*, 23 ARIZ. L. REV. 1267 (1981) (cost benefit analysis may be appropriate for statutes concerned with market failure, but its application across the board would raise "serious questions of separation of powers").

150. National Grain & Feed Ass'n v. OSHA, 866 F.2d 717, 729 n.22 (5th Cir. 1989); Sierra Club v. Costle, 657 F.2d 298, 407 (D.C. Cir. 1981).

151. *Sierra Club*, 657 F.2d at 404-05 n.519.

decision. Disclosure by the agency of its reasons for adopting an administration policy would help ensure that the decision is rationally based and that the agency has reached its own decision and has not merely deferred to the supervisory influence represented by the oversight process. Disclosure would also permit meaningful comment on a proposed rule and help identify the supporting basis for the rule.

#### A. *Identification of Regulatory Alternatives as Part of the Statement of Basis*

The Administrative Procedure Act requires agencies issuing rules to provide "a concise general statement of their basis and purpose."<sup>152</sup> The considerable judicial gloss on this provision has made it necessary for agencies to develop an administrative record at the time of proposal that discloses the basis of the rule.<sup>153</sup> The agency statement and record become the basis for comments by the public and are the focus for review. The United States Supreme Court has endorsed the need for an agency to supply an explanation for its rule that is consistent with "reasoned decisionmaking" and to "cogently explain why it has exercised its discretion in a given manner."<sup>154</sup>

In some circumstances, an agency is required to discuss the policy alternatives available and the agency's reasons for adopting the option selected. In *State Farm*, the Supreme Court held that the agency decision to rescind a regulation requiring passive restraints in automobiles was inadequate because of the failure to explain the reasons for not adopting the alternative of requiring airbags.<sup>155</sup> The airbag alternative was a technological alternative the agency recognized in an earlier version of the rule.<sup>156</sup> The Court disclaimed imposition of any requirement, however, that agencies discuss every policy alternative "regardless of how uncommon or unknown."<sup>157</sup>

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152. 5 U.S.C. § 553(c) (1988).

153. *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402 (1971). See also *Automotive Parts & Accessories Ass'n v. Boyd*, 407 F.2d 330, 338 (D.C. Cir. 1968) ("The paramount objective is to see whether the agency, given an essentially legislative task to perform, has carried it out in a manner calculated to negate the dangers of arbitrariness and irrationality. . . .").

154. *Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 42, 52 (1983). The *State Farm* decision confirmed the applicability of the "hard look" standard to informal rulemaking. See also Note, *OMB Intervention in Agency Rulemaking: The Case for Broadened Record Review*, 95 YALE L.J. 1789, 1805 (1986) (arguing that evidence of abrupt shifts in agency policy warrants judicial broadening of the record for review).

155. *State Farm*, 463 U.S. at 51.

156. *Id.*

157. *Id.* (citing *Vermont Yankee Nuclear Power Corp. v. National Resources Defense Council, Inc.*, 435 U.S. 519, 551 (1978)).

The obligation to consider alternatives has been recognized as extending to alternatives raised in comments, in the agency's proposal, and in related agency proceedings.<sup>158</sup> The alternatives requiring consideration may include "common and known or otherwise reasonable options."<sup>159</sup> The obligation to consider alternatives, however, has been criticized as imposing a burdensome and unpredictable standard on agencies that can dissuade regulation.<sup>160</sup>

When an agency submits a rule to OMB for review, the policy alternatives reflected in the agency draft represent more than an uncommon or speculative alternative. Instead, the alternative represents a considered agency judgment, if not a final judgment, that the alternative is a feasible and rational choice. Absent OMB comments, the agency would have presumably adopted the option as its official position.

Unlike the policy alternative considered in *State Farm*, the agency alternative in the draft rule has not been previously adopted by the agency, and does not become public, unless the draft is docketed or requested from OIRA after the rule is published. There has been no public reliance on an established agency policy.<sup>161</sup> Nonetheless, in this setting, a need remains for agency consideration of the reasons for the change. The initial option has been identified by the agency as an appropriate choice. Requiring an agency to articulate the reasons for adopting a different option serves the goal identified in *State Farm* of ensuring that the agency bring "its expertise to bear" with respect to the choice to be made in a considered way.<sup>162</sup>

The option ultimately adopted presumably has advantages over the agency's initial position, and those advantages led the agency to change

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158. Chemical Mfrs. Ass'n v. EPA, 919 F.2d 158, 166-67 (D.C. Cir. 1990) (EPA considered alternatives); Public Citizen v. Steed, 733 F.2d 93, 103 (D.C. Cir. 1984) (alternatives in related proceeding); International Ladies' Garment Workers Union v. Donovan, 722 F.2d 795, 815-18 (D.C. Cir. 1983) (alternatives in comments).

159. *Donovan*, 722 F.2d at 818. See also Williams Natural Gas Co. v. Federal Energy Regulatory Comm'n, 872 F.2d 438 (D.C. Cir. 1989) (need to discuss reasons for termination of proposed rule).

160. See Breyer, *Judicial Review of Questions of Law and Policy*, 38 ADMIN. L. REV. 363, 393 (1986); Pierce, *The Unintended Effects of Judicial Review of Agency Rules: How Federal Courts Have Contributed to the Electricity Crisis of the 1990s*, 43 ADMIN. L. REV. 7, 22-29 (1991). But see Shapiro & Levy, *Heightened Scrutiny of the Fourth Branch: Separation of Powers and the Requirement of Adequate Reasons for Agency Decisions*, 1987 DUKE L.J. 387 (the adequate reasons requirement serves as a form of scrutiny required by separation of powers).

161. See *Williams Natural Gas*, 872 F.2d at 444.

162. Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43, 54 (1983).

its views. It would not be rational to adopt a position that the agency recognizes is less beneficial than another available and feasible alternative. The agency needs to find that the second option is equivalent to, if not better than, the initial option.<sup>163</sup> The agency's initial choice and the policy adopted may represent rational alternatives. Because courts defer to agency decisions when the decision is rational, an agency could seek to rely on a statement that identifies support only for the option ultimately adopted. When both alternatives are rational, however, such a limited statement does not necessarily identify the factors and policy considerations that influenced the agency to change its views. Explaining the reasons for the change leads the agency to articulate the factors that influenced the choice and permits review of the grounds that influenced the decision.<sup>164</sup>

Moreover, the factor that influenced the agency to change its position may well be the administration's policy views. The Supreme Court recognized in *Chevron* that "an agency to which Congress has delegated policymaking responsibilities may, within the limits of that delegation, properly rely upon the incumbent administration's views of wise policy to inform its judgments."<sup>165</sup> When the administration's views influence an agency position, the agency should acknowledge the administration

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163. Executive Order 12,291 directs that the agency choose an alternative that achieves a regulatory goal at the least cost. Exec. Order No. 12,291, 3 C.F.R. 127 (1987), *reprinted in* 5 U.S.C. § 601 note at 473-76 (1988). This directive might be thought sufficient to explain the agency's basis for choice without the need for a specific discussion. However, this directive is so general that it has little value as guidance and is not objectionable as unduly directive. See Strauss & Sunstein, *supra* note 8, at 201. The agency's evaluation of the costs and benefits of the different regulatory options represents a real choice and the one for which more disclosure is needed.

164. See McGarity, *Presidential Control*, *supra* note 8, at 460-61.

165. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 865 (1984). The Court's discussion might be read as assuming that an agency's position reflects the views of the incumbent administration without any distinction between an agency and an administration view or any need for a special designation of an administration position. On the other hand, the reference to the agency's "reliance" on administration views suggests that there are circumstances when the policy views of the administration are a special factor in reaching a decision. When the agency takes account of the policy views of the administration, particularly those identified in the regulatory review process, to change the outcome the agency would have developed based on its more limited focus, recognition of the special significance of the administration policy views seems appropriate. For a discussion of the appropriateness of an agency taking account of the President's views in reaching a decision, see *Natural Resources Defense Council v. Hodel*, 865 F.2d 288, 315 (D.C. Cir. 1988) ("That the program permits the Secretary to heed the President's desires as the Secretary reconsiders minimum bid pricing for particular sales should be no source of discredit, so long as that review assures receipt of fair market value in light of prevailing market conditions.").

position as a relevant factor upon which the decision is based. This is consistent with requiring the statement of basis for a rule to specify the actual basis of the rule. The legislative history of the Administrative Procedure Act reflects that the statement accompanying the final rule should "with reasonable fullness explain the *actual* basis and objectives of the rule."<sup>166</sup>

### *B. Assurance of the Exercise of the Agency's Judgment*

Disclosure of the agency's acceptance of an administration position is also needed to ensure that the agency exercised its judgment and did not simply defer to an OMB position. The executive oversight process under Executive Order 12,291 is structured to give OMB positions special weight in agency decisionmaking.<sup>167</sup> Under the Order, agencies are required to base their decisions on certain cost-benefit principles to the extent permissible.<sup>168</sup> The agencies must submit their analyses to OMB for review before issuance and can issue their rules over formal OMB objections only after observing specified procedures.<sup>169</sup> These procedures include the provision of a written response to any written OMB objections to the "rulemaking file," thus making the different positions public.<sup>170</sup> Disputes over the application of the Order are to be referred to the Council on Competitiveness.<sup>171</sup> The Order directs agencies to refrain from issuing rules until review is completed, including indefinite extensions of time made by OMB.<sup>172</sup>

Oversight is to be advisory only.. It is not to displace the agency's statutory responsibility to make the decision.<sup>173</sup> To achieve this aim, the agency should be as free to disregard as to accept positions developed in the oversight process. The structure of the review program, however, makes it more difficult for an agency to issue a rule to which OMB objects than one the agency modified in response to OMB comments. Consequently, an agency may accept an OMB position, not because the agency agrees fully with the merits of the position, but in order to

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166. S. Doc. No. 248, 79th Cong., 2d Sess. 201, 259 (1946) (emphasis added). The Clean Air Act also requires that the agency discuss the policy considerations underlying a proposed rule and that the final rule indicate the basis for major changes made in the proposal. 42 U.S.C. § 7607(d)(3)(C), (d)(6) (1988).

167. See *supra* notes 23-30 and accompanying text.

168. Exec. Order No. 12,291, 3 C.F.R. 127 (1981), *reprinted in* 5 U.S.C. § 601 note at 473-76 (1988).

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.*

173. *Id.*

obtain the permission or clearance the agency views as necessary to issue the rule.<sup>174</sup> Experience under the oversight process shows that it influences agency decisions through negotiation and compromise and that agency officials may view OMB permission as necessary to issue a rule.<sup>175</sup> The need for disclosure depends, however, not simply on particular examples, but on the degree of supervisory influence created by the provisions of the Order itself.

The disclosure obligation can serve as a counterweight to the ability of OMB to object formally to a rule. When OMB formally provides written comments, the agency must respond in writing and must include both statements in the "rulemaking file."<sup>176</sup> The effect of inclusion in the rulemaking file for purposes of judicial review is not clear.<sup>177</sup> The statement could potentially become a factor in considering whether the agency decision is appropriate on the whole record, and in any event, the analysis by OMB will be available to those seeking review in formulating their positions. The Order makes disclosure of the agency and OMB positions a matter of public record, but does so only in the case of an agency decision to proceed despite formal OMB objections. A statement for the record of the agency's reasons for accepting OMB comments would ensure evenhanded consideration of the impact of OMB positions. The deliberations that affect a final decision would be subject

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174. See *supra* note 82. An agency has to refrain from publishing a rule until OMB completes its review. If the agency publishes a rule with which OMB disagrees, the agency must respond to formal OMB objections. This need to wait for OMB action before the agency publishes a rule gives the process some of the characteristics of a clearance system. *But see supra* note 38 and accompanying text.

175. See NAPA REPORT, *supra* note 9, at 5-6, 26-28; Bruff, *supra* note 8, at 568-74; Houck, *supra* note 8, at 540-41; Mason, *Current Developments in Federal Grant Law*, 4 PUBLIC CONTRACT NEWSLETTER 10 (1989) ("Rule-making coordination in the field of grants . . . has been grossly abused by OMB's agency arm-twisting. . . ."); Mason, *A Constitutional Problem*, 2 PUBLIC CONTRACT NEWSLETTER 21 (1987).

176. Exec. Order No. 12,291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988).

177. Section 9 of the Order states that the Order is not intended to create enforceable rights. However, under this section, the agency is required to base the decision on the whole record, including its determination under § 4 of the Order that the rule has substantial support in the record. The agency's responses to the OMB objections might be used to support arguments by those opposed to agency action that the decision was not adequately supported on the whole record or that the agency did not adequately consider the alternatives. See *Small Refiner Lead Phase-Down Task Force v. EPA*, 705 F.2d 506, 537-39 (D.C. Cir. 1983) (discussion of the availability of judicial review of a Regulatory Flexibility Analysis when the statute made analysis part of the whole record for review, but otherwise precluded separate review); McGarity, *Regulatory Analysis*, *supra* note 147, at 1322 (review of judicial consideration of regulatory impact analyses); Note, *Enforcing Executive Orders: Judicial Review of Agency Action under the Administrative Procedure Act*, 55 GEO. WASH. L. REV. 659 (1987) (arguing that judicial review over executive orders is proper under separation of powers).

to disclosure with respect to changes that OMB has successfully sought, as well as those for which OMB has been unsuccessful.

It is true that, in practice, OMB rarely objects formally to agency decisions. The significance of the OMB right to file objections lies, however, not in the frequency of its use, but in its availability to OMB. When an agency is not willing to make changes requested by OMB, the objection process has an added potential to induce the agency to accept OMB views.<sup>178</sup> In theory, the agency has the option, even now, to include a discussion of OMB's position in the Federal Register when the agency makes changes. However, the agency can be influenced in its use of this option by OMB.<sup>179</sup> The disclosure obligation should be judicially recognized or otherwise established as an obligation that binds OMB as well as the agency.

The statutes vest decisionmaking in the agencies. In view of the degree of influence that the administration can exercise under the Executive Order, a disclosure obligation is justified by the need to implement the statutory provisions that delegate decisionmaking authority to the agency.<sup>180</sup> An agency should accept an administration view because the agency is persuaded by the position and chooses to adopt it as an acceptable policy under the statute, not simply because the administration position is rational or would be sustained on judicial review.<sup>181</sup> The agency decision must involve more than deference to make meaningful an agency's decisionmaking responsibility under the law.

The agency's ultimate rule reflects an evolution of a position as a result of the oversight process. The agency, in its thought processes as an institution, must be mindful of its responsibility to make the decision, rather than simply deferring to OMB's desires. The agency cannot fully evaluate whether it is persuaded that the administration position has merit compared to the agency's initial position unless the agency identifies the reasons for the change in position.

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178. See Olson, *supra* note 8, at 45.

179. See *Health Claims Hearings*, *supra* note 9, at 121-22, 293, 295 (explanation of FDA staff memorandum recommending changes in Federal Register notice to refer to "lack of consensus in government," rather than a draft "acceptable to OMB," because "the truth about OMB would guarantee that they would stop the document").

180. The Executive Order cannot displace the agency's authority to make the ultimate decision. See *Environmental Defense Fund v. Thomas*, 627 F. Supp. 566, 570 (D.D.C. 1986) ("President's exercise of supervisory powers must conform to legislation enacted by Congress. . . . [T]he President may not, as a general proposition, require or permit agencies to transgress boundaries set by Congress.").

181. Exec. Order No. 12,291 provides that agencies shall give their "legal reasons" for not adopting the least costly alternative available and suggests that the agency's discretion to reach a decision different from that provided for under the principles in the Order is limited to situations in which the agency does not have the legal authority to do so.

A public statement requirement ensures greater attention by the agency because there is greater accountability to Congress and the public for the explanation. A public statement is also important because the agency is placed in a difficult position because it is subject to supervisory influence through executive oversight and remains responsible for its ultimate result. The agency is responsible for the decision whether to accept the influence by those who have an ability to affect the tenure of agency officials and resources or to "go public" if the agency does not accept OMB's views. The disclosure statement makes the agency accountable to those outside the executive branch for accepting an administration position as an agency policy and provides a safeguard that the agency has exercised independent judgment.

Although disclosure has importance for judicial review, the significance of the disclosure will be tested largely by public debate over the underlying policy and administration position. The disclosure will permit the public and Congress to learn how the general administration policy positions influence specific agency decisions. Discussion of the policy issues may lead to changes in the policy or may create more support for the policy. A major benefit of a disclosure obligation, and perhaps its most important role, will be to open up oversight decisions to increased political accountability.

Another benefit of a disclosure obligation will be to aid in understanding the nature of the agency's responsibility in reacting to views developed through the oversight process. The recognition of a disclosure obligation will clarify that the agency is obligated to exercise independent judgment. Oversight provides advice to the agency on its positions, but cannot displace the agency's judgment. The agency is statutorily responsible for decisions influenced by oversight and should be publicly accountable for them.

### *C. Meaningful Comments on a Proposal*

Disclosing that a proposed policy represents an administration position facilitates effective public comments on a proposed rule. The public should be informed about the proposal and any factors that may affect the agency's willingness to change it.<sup>182</sup> Disclosing that a policy reflects an administration as well as an agency policy is important for commenting on the proposed position because of the need to take account of the administration and the agency perspectives. When the public knows that a policy reflects an administration policy, this factor may

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182. With respect to the disclosure of factual premises, see *United States v. Nova Scotia Food Prods. Corp.*, 568 F.2d 240 (2d Cir. 1977); *Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 393-94 (D.C. Cir. 1973), *cert. denied*, 417 U.S. 921 (1974).

affect the type of policy considerations raised in the comments. The comments may emphasize the wider policy considerations reflected in the Executive Order. Moreover, the disclosure may affect the way in which the public comments. Comments might be sent to OMB and the agency for inclusion in the public record.

Sending public comments to OMB is undesirable from a policy perspective because it lessens the agency's role and displaces the agency docket as the focus of decisionmaking. OMB procedures provide for sending the agency copies of correspondence sent to OMB from the public.<sup>183</sup> Nonetheless, because OMB takes a role in the process, receives comments, and may meet with the public on agency rules, the opportunity to comment to OMB should be available to the public, especially for those proposals for which OMB has a position.<sup>184</sup> Indeed, if the public sends more comments to and requests more meetings with OMB, then the special effect of having comments transmitted by OMB to the agency may be diluted.<sup>185</sup>

#### *D. Need to Identify Administration Policy to Describe Basis*

The identification of a position as an administration position may be needed to describe adequately the scope and support underlying the policy of the proposed or final rule. If, for example, OMB adopted general risk assessment procedures like the ones it described for comment<sup>186</sup> and an agency used the new procedures in a proposed rule, reference to the use of the OMB risk assessment procedures would be appropriate to identify the agency's actions and its rationale. If an agency proposed the use of a regulatory budget — a policy that the administration has supported<sup>187</sup> — identification of the history of the policy and the administration's reasons for supporting it may provide the type of background and support for a rule that ordinarily is provided to facilitate comments and an understanding of the rule's basis. When an agency relies on a study from outside sources in developing a rule, the supporting studies are cited in the proposal in order to permit

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183. See *supra* text accompanying notes 103-06.

184. Olson, *supra* note 8, at 55-57 (discussion before OMB's adoption of its procedures with respect to conduit communications). See *supra* notes 100-06 and accompanying text (OMB procedures for transmitting comments to the agency and informing the agency of meetings).

185. See Bruff, *supra* note 8, at 579.

186. See *supra* notes 40-42 and accompanying text.

187. See *supra* notes 43-44 and accompanying text.

comment.<sup>188</sup> In addition, the agency will often cite its own studies or past policies either to support a proposal or to illuminate the issues. There would seem to be no need to treat OMB or administration positions differently in this respect.

#### *E. Appeal Procedures and Council on Competitiveness*

EPA's revision of the MWC rule, discussed above,<sup>189</sup> provides an example of an agency acknowledgment that administration policy views were a factor in the decisionmaking. In that case, the agency changed its position after a meeting with the Council on Competitiveness.<sup>190</sup> The Council functions to resolve issues concerning the application of the Executive Order.<sup>191</sup> A disclosure is especially needed when an agency changes a position based on review by the Council because of the Council's dispute resolution function. Although some disclosure was made in connection with the MWC rule, a need exists for an established procedure for disclosing decisions that have been influenced by the Council's review.<sup>192</sup>

### VII. CONSIDERATIONS WEIGHING AGAINST DISCLOSURE

Some factors weigh against the recognition of a disclosure obligation, whether the obligation is based on policy considerations or is viewed as a necessary element of rational decisionmaking under existing law. In particular, concerns may exist that the designation will intrude into the administrative decisionmaking process and upon the ability of the administration to oversee and supervise agencies.

#### *A. Intrusion Into Agency Decisionmaking Process*

The identification of an administration policy and a discussion of the reasons for not adopting the agency's initial position may be viewed as inconsistent with the lessons of *United States v. Morgan*<sup>193</sup> because such disclosure would open up the agency decisionmaking process for

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188. See *United States v. Nova Scotia Food Prods. Corp.*, 568 F.2d 240 (2d Cir. 1977).

189. See *supra* notes 48-51 and accompanying text.

190. MWC Rule, *supra* note 48, at 5497-98.

191. See Exec. Order No. 12,291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988) ("subject to the direction of the Task Force, which shall resolve any issues raised under this Order [or] ensure that they are presented to the President. . . .").

192. Even with a disclosure that the agency has changed its position, the question whether the agency exercised independent judgment remains. See *Brief for Petitioners, New York v. Reilly*, No. 91-1168 (D.C. Cir., appeal docketed Apr. 10, 1991) (petition for review of final agency rule). The disclosure provides a basis for evaluating the adequacy of the agency's reasons for changing its position.

193. 313 U.S. 409 (1941).

undue probing.<sup>194</sup> No similar need exists to have the agency disclose the options raised by agency subdivisions or the reasons for not adopting those options, except when statutorily required.<sup>195</sup> Discussions within the administration may be seen as the same as those within an agency which need no such acknowledgment. Moreover, the disclosure indirectly indicates the initial policy option of the agency, as presented to OMB, in addition to the position of the administration.

The rationale for treating administration policies differently is the supervisory character of oversight under the Executive Order. Although an agency head is free to weigh and reject views within the agency, the agency head has less freedom to weigh administration positions and to proceed despite differences. The agency head has supervisory authority over those in the agency. Thus, the decisions of the agency as an institution can be attributed to the agency head. In the oversight situation, OMB exercises supervisory influence with respect to the agency. The Executive Order establishes a review process that inevitably makes administration positions influential.<sup>196</sup> The procedural limitations on the OMB role, adopted by OMB and widely supported, demonstrate that OMB is not the same as the agency. Moreover, the Order itself reflects the institutional difference between the agency and those exercising an oversight function, particularly with respect to the procedure for enacting a rule despite OMB objections.<sup>197</sup>

#### *B. Effect on Oversight: Executive Privilege and the President's Supervisory Role*

*1. Impact on the Deliberative Process.*—The identification of administration policy may be viewed as unduly intruding on the deliberative process and the President's role in supervising administrative agencies. The Court in *Sierra Club v. Costle*<sup>198</sup> recognized a need for "consultative privacy" that makes the docketing of presidential communications concerning rules unnecessary absent any specific congressional intent to cover these communications.<sup>199</sup>

The District of Columbia Circuit also recognized in *Wolfe v. Department of Health and Human Services*<sup>200</sup> that agency-OMB communications are protected by the Freedom of Information Act exemption

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194. See *id.* at 422.

195. See, e.g., *United Steelworkers of America v. Marshall*, 647 F.2d 1189, 1210-16 (D.C. Cir. 1981), cert. denied, 453 U.S. 913 (1981).

196. See *supra* text accompanying notes 167-72.

197. See *supra* notes 31-32 and accompanying text.

198. 657 F.2d 298 (D.C. Cir. 1981).

199. *Id.* at 405.

200. 839 F.2d 768 (D.C. Cir. 1988).

for deliberative communications.<sup>201</sup> Under this decision, a regulatory log was exempt from disclosure not only because it would reveal the timing of pending decisions, but also because it would indirectly show the outcome recommended by the agency.<sup>202</sup> The dissenters agreed that disclosure was inappropriate to the extent it would have revealed the reasons and tentative conclusions of the agency, as distinct from the facts of the process.<sup>203</sup> Thus, in the context of disclosure of a log, the court as a whole regarded the agency's positions, submitted for OMB review, as predecisional matter protected by the deliberative process privilege.

The disclosure obligation considered in this Article does not relate to the disclosure of a specific agency document, nor does it involve disclosure in advance of the issuance of a final decision. Thus, there is no risk of precipitating a hurried decision on a pending matter. Such a risk formed part of the concern in the *Wolfe* case.<sup>204</sup> The disclosures would instead be made by the agency in the final opinion and would discuss the reasons for adopting a position the administration supports in place of the policy alternative initially recommended by the agency. There would be no disclosure of the give-and-take and possible revisions of views that are involved in developing the final or initial policy options. However, the concerns expressed in *Wolfe* about the protection of the deliberative process and the need to prevent chilling of frank discussion may arguably be at stake precisely because the disclosure would publicly reveal the initial recommendation of the agency to OMB.<sup>205</sup> According to the court, when "subordinates are reporting to superiors, disclosure could chill discussion at a time when agency opinions are fluid and tentative."<sup>206</sup>

The deliberative process protection, reflected in executive privilege, could be seen as extending not only to the discussions themselves, but to the ability to influence and change an agency's initial position. A concern may exist that the public disclosure of a different agency position may lock the administration into accepting that position, unless the administration is ready to accept the criticisms that may come with publicly "overturning" the agency position. The agency's acceptance, even preliminarily, of a particular position as a reasonable approach

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201. *Id.* at 776.

202. *Id.* at 775.

203. *Id.* at 778-79 (Wald, J., dissenting).

204. *Id.* at 776.

205. *Id.* at 775-76.

206. *Id.* at 776. See DeMuth & Ginsburg, *supra* note 8, at 1086 (agency and OMB disputes should be resolved by the President without being compromised by preliminary disclosures).

can give that option a patina of expertise and reasonableness that may have appeal, even when another option is adopted and justified as reasonable and acceptable.

The impact on the deliberative process, to the extent it occurs, would be a product of the effort to ensure a greater accountability for administration positions and to provide that the agency exercises its statutory responsibility to make the ultimate decision. Moreover, the chilling effect should not be overestimated. The administration would presumably be dissuaded by a designation that a policy is an administration policy only if the administration did not wish to have responsibility for its policy views attributed to it, but such an unwillingness should not necessarily be assumed or indulged if true.<sup>207</sup> If disclosure would chill the administration from taking a position, that interest should not be protected. Proponents of OMB review contend that review makes the government accountable. If the President and OMB are unwilling to make a decision because of adverse publicity, then the cause of democracy is not served by permitting them to avoid both disclosure and public opinion.

A second concern is that the agency will present a more popular view as its initial position because it knows the administration bears the onus of overriding that position.<sup>208</sup> However, under this recommendation, the agency would have to explain its reasons for changing its initial view and for accepting the administration policy as its own policy. Thus, the incentive for such posturing is limited.

A third concern is that the agency will become "locked into" its initial position because of the need to disclose changes. As a result, the agency may be reluctant to make changes and the administration may be less able to influence the agency.

The disclosure recommended in this Article can take the form of an acknowledgement of the other options considered by the agency and the reasons for selecting the one adopted. This format lends itself to acknowledgment by the agency that various alternatives were considered in formulating a policy. It is not uncommon for an agency to discuss other alternatives in proposed rules.<sup>209</sup> In issuing final rules, agencies

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207. See *supra* notes 48-52 and accompanying text (acknowledgment of the Council's views in the MWC rule). But see Olson, *supra* note 8, at 58-60 (discussion of OMB reluctance to have views identified).

208. See Bruff, *supra* note 8, at 587.

209. An agency's ability to revise a final rule to respond to comments without a reproposal is limited by the extent of notice of the scope of the regulatory issues. See *Small Refiner Lead Phase-Down Task Force v. EPA*, 705 F.2d 506, 546-47 (D.C. Cir. 1983). As a result, the agency has an incentive to discuss in the proposal the possible options that the agency may consider in issuing a final rule. See, e.g., National Emission Standards for Hazardous Air Pollutants, 53 Fed. Reg. 28,496, 28,497 (1988) (to be codified at 40 C.F.R. pt. 61).

often change their proposed views based on comments. Thus, an agency is not likely to consider itself precluded from changing its position merely because its initial position was different so long as the agency can explain its support for the position ultimately adopted. The Executive Order itself provides for the agency to discuss, in the regulatory analysis, the alternatives that could result in less cost and the legal reasons for not adopting a less costly alternative.<sup>210</sup> Thus, the disclosure of alternatives considered by the agency is not viewed as chilling the deliberative process of the agency when the agency has a position that may differ from the cost-benefit principles of the Executive Order. When the agency's initial position is changed by the oversight process, the alternatives considered by the agency need identification to ensure a rational decision. The consideration of these alternatives should similarly be viewed as not chilling discussion.

The disclosure should indicate that the agency took account of administration views in adopting its ultimate position. Some may view this additional disclosure as particularly detrimental to the deliberative process and the ability to influence the agency's views. Such a disclosure obligation, however, may contribute to the quality of the policy discussions and serve to enhance the deliberative process. At present, agencies may simply incorporate the policy they perceive as representing OMB views into draft rules submitted to OMB and may resist OMB policy views largely on the grounds of their legal defensibility.<sup>211</sup> A policy that calls for disclosure of the agency's initial views encourages the agency to formulate its own policy position because the agency would know that these views would receive careful consideration in the internal policy debate. The need to state the reasons for changing the initial position would also focus attention on important substantive policy issues. In the end, a disclosure policy is likely to affect the ease with which the administration is able to influence an agency. An agency may be less willing to change its position if a satisfactory public explanation cannot be provided for changing the position. This impact of a disclosure policy is desirable in reinforcing the agency's responsibility to make the ultimate decision.

The agency's role is different from the ordinary situation in which the subordinate provides advice and the superior is officially and publicly responsible for the decision. In the ordinary setting, the superior will endeavor not to chill the preliminary views of subordinates because the superior wants to hear the full range of options before deciding on one

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210. See *supra* notes 25-27 and accompanying text.

211. See Olson, *supra* note 8, at 50 (EPA drafts rules that the agency believes will clear OMB).

for which the superior will be accountable. In the oversight setting, the agency, while "subordinate" to supervisory influence, is statutorily responsible for the decision. There needs to be concern in this setting, both with the quality of the discussion and the risk that discussions with a "superior" may chill the subordinate-agency in its responsibility to make the ultimate decision. That risk is of special concern in the oversight setting when the agency is not as free to disregard the advise as to accept it. If the agency disagrees, OMB may file formal public objections, continue to extend the time for review, and refer disputes to the Council on Competitiveness. The disclosure obligation recommendation in this Article makes an agency's acceptance of OMB views public, just as an agency decision to disagree with OMB is public when OMB formally objects. Disclosure helps ensure that the OMB views are indeed only advisory and do not displace the agency's decisionmaking responsibility.

An additional risk of a disclosure policy is that agencies may become reluctant to state a forceful initial position or any position at all. When the agency changes its view, it must disclose the change and provide a defensible basis for the ultimate outcome. Faced with this difficulty, the agency may not present a position initially. However, this possibility has a check because the agency would still have to acknowledge in the rule that the position adopted was developed in conjunction with the administration as an administration policy. The agency should also discuss any alternatives seriously considered, even if the agency did not have an initial position. An agency reluctant to explain its changed position may be reluctant to be in the position of having no views. Thus, overall, the disclosure obligation is likely to encourage an agency to formulate and pursue its policy views.

The administration might also seek to intervene in the process before the agency develops an initial view, so that the administration could more easily affect the outcome. If OMB intervenes, the position developed in conjunction with OMB should still be designated as an administration position. Furthermore, if earlier OMB intervention in agency decisions becomes established as a general policy, the OMB policy should be described in a general notice published in the Federal Register.<sup>212</sup> The publication of the policy is important to permit public discussion and consideration of the limits that may be needed for the new process. A new Executive Order may also be needed if the practice represents a modification of the existing Order.

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212. Publication of general statements of policy is called for under the Freedom of Information Act, 5 U.S.C. §552(a)(1)(D) (1988). See also *Sierra Club v. Andrus*, 581 F.2d 895, 902 (D.C. Cir. 1978); *Davis*, *supra* note 85, at 856. The President may be considered not to be an agency. See *Armstrong v. Bush*, 924 F.2d 282 (D.C. Cir. 1991).

2. *Executive Privilege.*—The appropriateness of disclosure of administration policy in rulemaking must also be considered with respect to whether it will unduly intrude on the President's constitutional role. Executive privilege protects the President's ability to exercise the constitutional function of supervising agencies.<sup>213</sup> Although that privilege has been stated in broad terms, in practice, administrations have agreed to limits on the privilege that implicitly recognize a need to balance the privilege against other appropriate concerns.<sup>214</sup>

In analyzing separation of powers questions when there is a risk of one branch of government aggrandizing its powers at the expense of another, the Supreme Court uses a formalist analysis, establishing a bright line test to provide boundaries.<sup>215</sup> Absent a risk of aggrandizement, a functional approach that considers the needs of each branch to protect its core functions is appropriate.<sup>216</sup> Executive privilege involves the overlapping interests of the three branches of government with respect to administrative agencies. The President has an interest in supervising agencies, but Congress and the courts also have interests in ensuring that the agencies properly exercise their statutory responsibilities. In balancing those interests, the need for confidentiality is especially strong with respect to protecting direct presidential communications and pending decisions because these disclosures would most adversely affect decisionmaking and the President's functions.<sup>217</sup> In analyzing restrictions that impact on executive privilege, it is appropriate to consider the additional benefits provided by fostering openness and the additional burdens of disclosure and the "interference with the values served by confidentiality."<sup>218</sup>

Many of the elements in this test have been discussed separately, but a summary of the balance of factors and the marginal contribution of the disclosure policy is useful. The disclosures would indeed increase the burdens on the agency by requiring an affirmative disclosure of the policy options and reasons for adopting an administration policy. The inclusion of that discussion in the rulemaking record would also open up the possibility of judicial review with respect to the rationality of

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213. See *United States v. Nixon*, 418 U.S. 683, 703-16 (1974); *Wolfe v. Department of Health & Human Servs.*, 815 F.2d 1527, 1538-40 (D.C. Cir. 1987) (Bork, J., dissenting).

214. See *Bruff*, *supra* note 8, at 585.

215. See *Commodity Futures Trading Comm'n v. Schor*, 478 U.S. 833, 856-57 (1986). Formalist tests have been used in several cases. See, e.g., *Bowsher v. Synar*, 478 U.S. 714 (1986); *INS v. Chadha*, 462 U.S. 919 (1983); *Buckley v. Valeo*, 424 U.S. 1 (1976).

216. See *Schor*, 478 U.S. at 856-57.

217. See *Nixon*, 418 U.S. at 708; *Bruff*, *supra* note 8, at 585.

218. *Bruff*, *supra* note 8, at 586.

the decision in light of the options and factors identified by the agency. The disclosure policy would not affect the confidentiality interests most strongly protected by executive privilege because there would be no summary of oral communications or disclosure of a pending decision. There may be some indirect impact on the deliberative process and the ability of the administration to influence an agency. The agency's willingness to change a position will depend upon whether there is a sufficient basis for explaining why the alternative adopted is satisfactory.

The designation in a rule that a policy represents an administration position and the identification of other policy options considered by the agency encourages openness by allowing the public to determine the impact of oversight more readily. Disclosure permits public and congressional discussion of the merits of administration policies, thus placing that matter in the public arena. This provides added assurance that the agency considered the appropriateness of adopting an administration policy and did not merely acquiesce in the policy because of its minimal reasonableness.

Moreover, executive privilege is limited to the extent necessary to comply with the law.<sup>219</sup> These disclosures help to ensure that the agency fully considered the appropriateness of adopting an administration policy and did not simply acquiesce in a policy because of its minimal rationality.<sup>220</sup> If that analysis is correct, executive privilege should not preclude disclosure that provides the appropriate assurance that the agency exercised its judgment after adequately considering the alternatives while minimizing the impact on the deliberative process.

3. *Docketing of Drafts and Disclosure Policy.*—The practice of docketing agency drafts submitted for OMB review provides indirect support for the finding that the disclosures recommended here would not unduly intrude into the deliberative process protected by executive privilege. Some agencies include the drafts in their docket, and OIRA makes the drafts available upon a written request. The disclosures called for in this Article would serve to make information more readily available to the public that could with greater difficulty be obtained by comparing the draft available in the agency or OIRA docket.<sup>221</sup> Docketing makes it possible to identify the initial agency position generally and to discern

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219. See *United States v. Nixon*, 418 U.S. 683, 706-07 (1974); *Environmental Defense Fund v. Thomas*, 627 F. Supp. 566, 570 (D.D.C. 1986) (although a certain amount of deference must be given to the President to control executive policymaking, use of Exec. Order No. 12,291 to create delay and to impose substantive changes raises constitutional questions).

220. See *supra* text accompanying notes 167-72.

221. For a similar disclosure provision, see *supra* notes 109-17 and accompanying text.

indirectly the impact of the oversight process. Because OMB has agreed to the voluntary adoption of these indirect means of disclosing the agency position, a direct disclosure of the initial agency position and a change in position should not be seen as unduly chilling the deliberative process.

On the other hand, the recommended disclosure policy goes beyond the docketing practice and includes disclosure in the Federal Register, makes the disclosures part of the record for judicial review, and expressly indicates when changes reflect an administration policy, as opposed to a last minute change solely at the agency's initiative. Some may question the marginal benefit of a disclosure requirement as compared to the existing docketing practices, given these added burdens on the agency and the impact on confidentiality and the deliberative process. However, the disclosures provide an additional benefit: they promote openness by making the impact of administration input more readily discernible to the general public. The public is less likely to have access to the OIRA or agency docket or to be able to compare routinely the draft with the rule to discern differences. Moreover, under this recommendation, the agency must discuss the reasons for choosing between its initial policy options and the final one, thus providing additional assurance of agency attention to its statutory responsibility to make the decision.

This disclosure policy should not, however, be viewed as a substitute for the docketing of agency drafts. The docketing provision provides information about the evolution of the full agency position during the oversight process. This recommendation and the docketing provisions are complementary in assuring accountability and openness in the process.

4. *Presidential Communications.*—There may be a concern that a disclosure obligation will intrude on the President's personal responsibility under the Constitution to supervise administrative agencies. The doctrine of executive privilege has been viewed as protecting the ability of the President to consult with and to exercise a supervisory role over the executive branch.<sup>222</sup> The President normally must operate through delegation, and the privilege, with its constitutional aspects, has been viewed as applying to the President's delegates, although perhaps with diminished force.<sup>223</sup>

This Article's recommendation is directed at oversight that occurs as part of the process established under Executive Order 12,291, rather

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222. See *Nixon*, 418 U.S. at 708; Rosenberg, *Beyond the Limits*, *supra* note 8, at 242 (presumptive privilege extends only to communications with closest advisers to thrash out policy, not policy recommendations to agencies); Verkuil, *Jawboning*, *supra* note 8, at 978-82.

223. See *Wolfe v. Department of Health & Human Servs.*, 815 F.2d 1527, 1539 (1988) (Bork, J., dissenting); Strauss, *supra* note 65, at 660-61 (need for the President to act through delegation); Verkuil, *Jawboning*, *supra* note 8, at 988-89.

than any individual communications between the President and the agency. OMB oversight occurs under the terms of the Executive Order and is bound by the Order. The process establishes a review system that gives OMB positions added influence in the decision, which makes it more difficult for an agency to reject than to accept OMB views. When agencies disagree, they must respond for the rulemaking record to any formal OMB written comments, deal with appeals to the Council on Competitiveness, and expect OMB extensions of time for additional review.<sup>224</sup> If the agency issues a rule before OMB has completed its review or while review has been suspended, the agency has not complied with the terms of the Executive Order.<sup>225</sup> In addition, the Executive Order requires consideration of factors that may not be explicit in the statute.<sup>226</sup> This process is routine for all major agency rules. This type of supervisory influence warrants additional restrictions to ensure that there is no displacement of the agency's statutory responsibility to make the ultimate decision.

Communications from the President differ because of the President's personal constitutional responsibility to enforce the law.<sup>227</sup> The President also has the ability to define the basis of the communications in a way that differs from those under the Executive Order. The discussion may be consultative and may leave the matter to the agency to decide in light of the discussion. Presidential communications directed to the agency are also likely to be infrequent contacts dealing with exceptional circumstances. Although presidential communications need not be subject to the same restrictions that apply to those exercising oversight under the Executive Order, the recommendations may be appropriate on a policy basis even with respect to presidential communications. The contents of the communications themselves are not directly disclosed. The policy can be described as an administration policy and not specifically as a presidential policy. Thus, this approach has a limited impact on the consultative privacy of presidential communications.

Communications between White House officials and the agency that occur as part of the oversight process established by the Executive Order

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224. See Exec. Order No. 12,291, 3 C.F.R. 127 (1981), reprinted in 5 U.S.C. § 601 note at 473-76 (1988).

225. *Id.* See also *Health Claims Hearings*, *supra* note 9, at 118 (remarks of FDA Commissioner that “[I]f OMB does not concur, I do not believe those rules can be published.”).

226. See *supra* note 149 and accompanying text.

227. The President is personally responsible under the Constitution to “take Care” that the laws are faithfully executed. U.S. CONST., art. II, § 3. See Verkuil, *Jawboning*, *supra* note 8, at 978-89.

should be covered by the recommendation because these communications reflect the supervisory influence established by the Executive Order. Furthermore, coverage ensures that oversight functions under the Executive Order are not simply shifted to White House or other officials outside OMB to avoid the restraints placed on OMB because of its oversight function under the Order.<sup>228</sup>

### C. Appropriateness of Judicial Review

A need to designate administration policy as part of the basis of agency rules may appear inconsistent with the thrust of judicial decisions which have not indicated any need for such acknowledgments in the cases dealing with executive oversight. Indeed, the *Chevron* Court expressly recognized the appropriateness of agency responsiveness to political views of the administration, without any discussion of disclosure.<sup>229</sup> In *Sierra Club*, the court of appeals noted that drafts submitted to OMB, which the statute required be made part of the public docket, were not included in the record for review because Congress presumably recognized that it did not matter which person within the administration affected the decision.<sup>230</sup> In *State Farm*, the Court examined the rationality of an agency decision without discussing the process.<sup>231</sup> *State Farm* provides some suggestive support for the appropriateness of identifying administration policies when the policies affect agency decisions. The dissent by then Justice, and now Chief Justice, Rehnquist indicates that a policy stated to be a new administration's policy would provide support for a change in position.<sup>232</sup> The majority, while not discussing the weight of an administration policy directly, rejected the related substantive argument made by the agency that adverse public reaction warranted the revision of the standards.<sup>233</sup> The rejection occurred not because that point lacked relevance in supporting a decision, but because it was not one of the reasons for the agency's decision.<sup>234</sup> The lesson seems to be that to the extent an administration position is a relevant consideration supporting a rule, the agency must explicitly acknowledge the administration position and the basis for it in the statement of basis accompanying the rule and must seek to identify the policy basis underlying the position.

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228. See Bruff, *supra* note 8, at 588.

229. *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 853-59 (1984).

230. *Sierra Club v. Costle*, 657 F.2d 298, 404-05 n.519 (D.C. Cir. 1981).

231. *Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

232. *Id.* at 59 (Rehnquist, J., dissenting).

233. *Id.* at 50.

234. *Id.*

The need to identify the administration policy or the impact of oversight was not directly at issue in these cases. Moreover, *Sierra Club* arose before the systematic oversight process of Executive Order 12,291 was developed, and the case specifically concerned presidential communications.<sup>235</sup> The appropriate parameters for executive oversight remains an issue yet to be fully tested.

The courts also noted the appropriateness of congressional development of limits on the oversight process. Congress has not done so directly, but the need to obtain presidential approval creates difficulties in enacting general statutes that limit the President's ability to influence the agencies. Instead, Congress established statutory time limits and mandatory duties in specific statutes as a means of limiting executive oversight.<sup>236</sup> However, such an approach has its own limits.

Developing a suitable means to account for the significance of executive oversight without unduly intruding on the President's role remains a difficult task. Courts may be willing to recognize limits on the supervisory role if the tests are manageable and take account of the underlying separation of powers concerns. The measures suggested here seem reasonably responsive because they provide more accountability for oversight without unduly intruding into the process. The issues are difficult, and there may not be a fully satisfactory resolution of the competing interests. Yet, the need remains to develop some means to reflect the impact of executive oversight adequately in the process of agency decisionmaking. A disclosure obligation is important as a means to ensure that the agencies perform their statutory role to make the decision in a rational manner.

Lastly, there may be concerns about the scope of judicial review in cases involving an agency decision to adopt an administration position. The *State Farm* decision provides for a "hard look" at the agency's rationale.<sup>237</sup> These restraints on discretion may be viewed as inappropriate limits on presidential power. The availability of review may also be thought to open up difficult and unmanageable questions for review. The test for review of an agency decision, as influenced by the oversight process, presents some novel questions, but the test should build on the existing standards. The application of judicial review will require the agency to identify the relevant factor that led the agency to change its initial view. That factor may be the identification of an administration

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235. *Sierra Club v. Costle*, 657 F.2d 298, 388, 404 (D.C. Cir. 1981). The communications in *Sierra Club* involved an informational briefing. See Olson, *supra* note 8, at 35.

236. See *supra* notes 127-33 and accompanying text.

237. *Motor Vehicle Mfrs. Ass'n of the United States, Inc. v. State Farm Mut. Auto Ins. Co.*, 463 U.S. 29, 43 (1983).

policy and its policy basis.<sup>238</sup> Thus, the additional support needed by the agency may not be extensive or onerous to develop. However, whether the administration's views were in fact sufficient will, in the end, depend upon the particular issues involved.

The fact that an initial agency position did not become final should also be considered in assessing the extent of the support needed for the position adopted. When an agency changes an established public policy, the agency must have more support than would be required to justify a new policy. Under the *State Farm* decision, a change in the *status quo* requires additional support.<sup>239</sup> This burden is especially appropriate in view of the reliance interest that develops on the part of the public.

The oversight process involves agency positions that are in the process of development. The reliance of the public on existing rules is not a factor. Consequently, a change in a rule that has not been issued may be "more easily defensible" than a change in an existing rule that affects the *status quo*.<sup>240</sup> Thus, a change made during the oversight process may be considered rational if the agency reasonably finds the option equivalent, but not necessarily better, than the initial option considered. An agency decision to change its initial position is not appropriate if the agency considered the alternative adopted to be a worse option. However, the option may not have to be better than the initial one because there has been no public reliance on an established agency position and because administration views can play a role in informing and supporting agency decisions.

In practice, the disclosure obligation may not change the outcome on judicial review in many cases. Nonetheless, the obligation is important because it can serve to assure adequate attention within the administration to the rationale for the changes. These reasons must satisfy the agency and be adequate to deal with congressional and public reactions, in addition to meeting the test for judicial review. The public accountability for the choice made is a major factor in ensuring its rationality.

#### D. Distinguishing Administration from Agency Policy

Distinguishing between administration and agency policies is made difficult by the process of negotiation and compromise that occurs during oversight. OMB may view the process as the provision of advice and

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238. See *supra* note 165 and accompanying text.

239. *State Farm*, 463 U.S. at 42.

240. *Williams Natural Gas Co. v. Federal Energy Regulatory Comm'n*, 872 F.2d 438, 444 (D.C. Cir. 1989) (standard of review for withdrawal of a proposed rule).

a "socratic dialogue."<sup>241</sup> OMB may also perceive changes made by the agency in response to oral comments from OMB as agency-initiated policies, rather than administration policies.

As discussed above, the oversight process poses a risk of displacing the agency decision. The process makes it more difficult for the agency to disagree than to agree, thereby inducing negotiation and compromise.<sup>242</sup> If the process does not displace the agency decision, it represents a shared decision. Therefore, the OMB role in reaching the decision should be acknowledged.<sup>243</sup> Thus, when an agency position changes as a result of the oversight process, the change should be viewed as representing both an agency and an administration position. The administration has contributed to shaping the outcome by virtue of its views and the added influence the oversight process provides. Even though OMB may not obtain as many changes as sought, its views help shape a compromise decision. The policy also represents an agency position because the agency should not accept the position if it is not persuaded of its merit and rationality. Thus, any change made in an initial agency position because of oral or written comments from staff or through formal comments during the oversight process should be disclosed as representing an administration and agency policy.

There may be occasions, however, when the oversight discussions lead to changes of a nonsubstantive nature or insignificant changes to correct errors. An agency change in these circumstances will not need disclosure as an administration position. These changes are ones that the agency would have made on its own initiative to correct a mistake, whether the issue was raised by the administration or by others, even if review was concluded with no changes. When, however, the views expressed during the oversight process influence the agency in choosing between two reasonable positions or represent a significant change, there should be disclosure that the policy represents a joint administration and agency position.

The need to designate a policy as an administration policy may also serve to clarify the administration position. The oversight process involves compromise, and OMB may only comment by stating objections.<sup>244</sup> The

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241. See *Health Claims Hearings*, *supra* note 9, at 172 (OIRA Acting Administrator MacRae's testimony that "we provide advice; we do not clear rules"); Houck, *supra* note 8, at 544 (citing *Senate Democrat Leaders Lambast OMB for Control Over Environmental, Safety, Health, Rules*, 16 ENV'T REP. (BNA) 1807 (Jan. 31, 1986)).

242. See *supra* text accompanying notes 167-78.

243. See *Health Claims Hearings*, *supra* note 9, at 179 ("An agency comes in with a proposal, we will have discussions, and we will mutually agree on changes, and the rule will go out.").

244. See *id.* at 177-80 (examples of confusion about the proper role of OMB).

agency may assume, based on OMB comments, that OMB wants a particular change, which the agency then proposes. At the same time, OMB might assume that the revised position is "really" an agency initiative because the agency suggested the revision. When the agency is required to designate the policy as an administration position, OMB must focus more clearly on whether the policy change exceeds OMB's views of what is needed. Moreover, the designation ensures that the administration is willing to assume responsibility for changes that OIRA staff members induce the agency to make. The responsibility for jawboning the agencies is too important to be delegated to the OIRA staff without holding OIRA and the administration institutionally accountable for the decisions affected.

### VIII. CONCLUSION

The identification of the impact of administration policy on the development of agency rules during the oversight process has policy benefits. Requiring disclosures of changes in agency rules that occur as a result of oversight improves both administration and agency accountability for decisions made. The need to identify administration policy in a public statement also encourages articulation of the administration's general policy positions rather than merely second-guessing of agency decisions. In addition, disclosure is important for purposes of judicial review because it ensures that the rules disclose the factors that have influenced the decision. Agency decisions affected by the oversight process may involve a choice between two rational policy options which the agency considered acceptable. The disclosure assures an identification of the factors that persuaded the agency to adopt the position chosen rather than its initial position.

Disclosing that the agency accepted an administration position will also provide a safeguard that the agency exercised the judgment delegated to it under statute based on factors that the agency considers appropriate. The Executive Order makes it more difficult for an agency to issue a rule to which OMB objects. If the agency disagrees and OMB formally objects to the agency rule, the agency must include a response in the rulemaking file. In addition, the agency may face further delays because of OMB's extended review and because of possible appeals to the Council on Competitiveness. Disclosure for the record of an agency's reasons for agreeing with OMB provides balance and helps ensure that OMB advises, but does not displace, the agency decision. A disclosure obligation is appropriate under a model of agency decisionmaking that views agencies as having an independent obligation to determine policy, as compared to a deference model in which the agency can be influenced to accept any administration position that is minimally rational.

Recognizing a disclosure obligation may have an indirect effect on the deliberative process and may reduce the ability of the administration to influence the agency decision. Such diminished influence over agencies might be viewed by some as an inappropriate intrusion into the deliberative process protected by executive privilege. The give-and-take of executive and agency communications in thrashing out a position would not be disclosed, however. The impact on the deliberative process occurs indirectly when the administration is reluctant to accept accountability for influencing the decisions actually reached or when the agency finds that it cannot state a satisfactory basis for changing its initial position in light of the public disclosure.

Still, the agency and oversight process may be characterized as a single predecisional step. Separate identification of an initial agency position may be thought to be an unnecessary and undesirable intrusion into the decisionmaking process. However, the Executive Order recognizes the agency decisionmaking process as a distinct matter for disclosure in the public record when the agency disagrees with a formal OMB position. Furthermore, by law or under OMB policy, the drafts of rules are included in the public record, but not in the record for judicial review. The availability of drafts indirectly discloses the deliberative process and differences between OMB and the agency, but the form of disclosure makes the impact of the OMB positions difficult for the public to determine.

The administration has a recognized role in influencing agency decisions, but that influence cannot exceed the statutorily delegated responsibility to the agency. A recognition in the public record of the distinct contribution of administration positions provides enhanced accountability to the public. Moreover, disclosure provides better assurance that the agency will exercise its distinct statutory responsibility.<sup>245</sup> The disclosure obligation ensures the accountability of the administration and the agency and serves to identify the impact that executive oversight has on agency rulemaking decisions.

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245. Absent a legislative change, the policy considerations support such a disclosure obligation, even if the obligation is not viewed as necessary for purposes of judicial review. Disclosure of the initial option considered by the agency and the agency's adoption of an Administration policy could be made in the public docket, if not in the record for judicial review.

# **Supplanting Government Regulation with Competitor Lawsuits: The Case of Controlling False Advertising**

**Ross D. PETTY\***

## **INTRODUCTION**

In this period of hundred billion dollar federal budget deficits, fiscal austerity and privatization have become critical concepts for the Bush Administration. This is particularly so because the President was elected on a campaign that promised to follow President Reagan's fiscal policies with the slogan "read my lips, no new taxes." In this economic and political climate, it is not surprising that the Federal Trade Commission's advertising program has been "downsized." It also is not surprising that private competitor advertising litigation has expanded, as if to fill the void.

The recent American Bar Association report on the Federal Trade Commission (FTC or Commission) noted that FTC resources for advertising enforcement were cut 42% from fiscal years 1978 to 1987, from 24% of the total consumer protection resources to 17.03%.<sup>1</sup> Some of these resources were redirected against fraud, including advertising fraud.<sup>2</sup> However, according to the report, there is still a perception that the FTC "has largely abandoned the regulation of advertising, especially national advertising."<sup>3</sup>

In contrast, commentators have noted the rise of private lawsuits, predominantly filed by competitors, challenging false advertising under

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1. Report of the ABA Section of Antitrust Law Special Committee to Study the Role of the Federal Trade Commission, *reprinted in 58 ANTITRUST L.J. 43, 71 n.41 (1989)* [hereinafter ABA Report].

2. *Id.* at 80, 151.

3. *Id.* at 70-71. See also Cohen, *FTC Memo Hits Ad Self-Regulation*, *ADVERTISING AGE*, Feb. 7, 1983, at 42 ("During a year when the ad industry self-regulation system identified nearly 60 instances where national advertisers were making claims that could not be substantiated, the Miller management at the FTC failed to act against a single case involving national ads that have run in major media since the present regime took office."); McGrew, *Advertising Issues Avoided by the FTC in Past Year*, *Legal Times*, Jan. 7, 1985, at 12.

the Lanham Act, which they note has been recently amended to make competitor litigation more likely.<sup>4</sup> The Lanham Act generally has been limited to suits in which the plaintiff alleges business, rather than consumer injury.<sup>5</sup> In the premier case denying consumer standing, *Colligan v. Activities Club of New York, Ltd.*,<sup>6</sup> the court stated that "Congress' purpose in enacting § 43(a) was to create a special and limited unfair competition remedy, virtually without regard for the interest of consumers generally."<sup>7</sup> The court in *Ragold, Inc. v. Ferrero, U.S.A., Inc.*,<sup>8</sup> was equally blunt: "[P]rivate litigation under the Lanham Act seeks primarily to regulate business competition, with any benefit to the consuming public incidental."<sup>9</sup>

However, this view has been strongly criticized as inconsistent with the plain meaning of the Act and its legislative history.<sup>10</sup> Today, most courts recognize that there is a "strong public interest" in using the Lanham Act to prevent misleading advertising.<sup>11</sup> This public interest component is comparable to the FTC's statutory mandate.<sup>12</sup> The predominance of competitor plaintiffs in Lanham Act false advertising lawsuits and the availability of a comparable regulatory agency make false advertising a suitable subject for comparing government regulation with competitor lawsuits as a means of promoting public interest.

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4. 15 U.S.C. § 1125(a), *amended by* Pub. L. No. 100-667, tit. I, § 132, 102 Stat. 3946 (1988). For commentary on the increasing numbers of lawsuits, see Buchanan & Goldman, *Us vs. Them: The Minefield of Comparative Advertising*, 67 HARV. BUS. REV. 38 (1989); Trachtenberg, *New Law Adds Risk to Comparative Ads*, Wall St. J., June 1, 1989, at B6.

5. The one exception when a consumer was allowed to sue under the Lanham Act is *Arnesesen v. Raymond Lee Org., Inc.*, 333 F. Supp. 116 (C.D. Cal. 1971).

6. 442 F.2d 686 (2d Cir.), *cert. denied*, 404 U.S. 1004 (1971). See also *Johnson & Johnson v. Carter-Wallace, Inc.*, 487 F. Supp. 740 (S.D.N.Y. 1979).

7. *Colligan*, 442 F.2d at 692.

8. 506 F. Supp. 117 (N.D. Ill. 1980).

9. *Id.* at 125 n.9. See also *American Home Prods. Corp. v. Johnson & Johnson*, 436 F. Supp. 785, 797 (S.D.N.Y. 1977) ("an action under the Lanham Act . . . is not the proper legal vehicle in which to vindicate the public's interest in health and safety"), *aff'd*, 577 F.2d 160 (2d Cir. 1978).

10. See, e.g., Morris, *Consumer Standing to Sue for False and Misleading Advertising Under Section 43(a) of the Lanham Trademark Act*, 17 MEM. ST. U.L. REV. 417, 430-32 (1987); Thompson, *Consumer Standing Under Section 43(a): More Legislative History, More Confusion*, 79 TRADEMARK REP. 341 (1989).

11. See, e.g., *American Home Prods. Corp. v. Johnson & Johnson*, 654 F. Supp. 568, 590 (S.D.N.Y. 1987). See also *Coca-Cola Co. v. Proctor & Gamble Co.*, 822 F.2d 28, 31 (6th Cir. 1987); *Stiffel v. Westwood Lighting*, 658 F. Supp. 1103, 1116 (D.N.J. 1987) ("Because the public as well as competitors are to be protected from false . . . advertising . . .").

12. 15 U.S.C. § 45(b) (1988) requires that the Commission action be in the public interest. See *FTC v. Klesner*, 280 U.S. 19 (1929). The Commission has "broad discretion" to make this determination. See *Ford Motor Co. v. FTC*, 120 F.2d 175, 182 (6th Cir.), *cert. denied*, 314 U.S. 668 (1941).

Section I of this Article discusses the policy implications of public and private regulation. Section II describes the similarities and differences of proving false advertising, including remedial consequences, between the FTC Act and the Lanham Act. Section III examines cases brought under each statute in the past ten years, and Section IV presents four types of specific case comparisons. Finally, an overall evaluation is made.

## I. POLICY CONSIDERATIONS

### A. *Market Incentives for False Advertising*

Jordan and Rubin argue that the common law is economically efficient.<sup>13</sup> They believe that the market provides few incentives for false advertising because consumers can verify most claims through product examination or use.<sup>14</sup> Moreover, allowing competitors to sue one another for false advertising might discourage useful advertising and make entry more difficult. They argue that for these reasons, the common law efficiently limited a firm's legal recourse against a rival's advertising.<sup>15</sup> Common-law courts were reluctant to allow businesses to sue for redress against a rival's advertising misrepresentations even when such misrepresentations took business away from the injured firm.<sup>16</sup>

If the rival misrepresentations concerned: (1) the identity of the manufacturer of its products (*i.e.*, "passing off" its products as those of the plaintiff); (2) the plaintiff's personality or character (defamation); or (3) the plaintiff's products (disparagement), the common law allowed suit.<sup>17</sup> However, for disparagement, the courts typically would not grant an injunction, but would only award special damages, which had to be proven with considerable specificity.<sup>18</sup> The plaintiff also had the burden of proving

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13. Jordan & Rubin, *The Economics of False Advertising*, 8 J. LEGAL STUD. 527, 535-40 (1979).

14. *Id.*

15. *Id.*

16. See, e.g., Ely-Norris Safe Co. v. Mosler Safe Co., 7 F.2d 603, 604 (2nd Cir. 1925) ("The law does not allow him [the damaged competitor] to sue as a vicarious avenger of the defendant's customers," but does allow injunctive relief if diversion of trade can be proven."), *rev'd on other grounds*, 273 U.S. 132 (1927); American Washboard v. Saginaw Mfg. Co., 103 F. 281 (6th Cir. 1900) (no relief). See also Schulman, *False Advertising: A Discussion of a Competitor's Rights and Remedies*, 15 LOY. U. CHI. L.J. 1, 4-8 (1983); Note, *Developments in the Law: Competitive Torts*, 77 HARV. L. REV. 888, 905-07 (1964).

17. See, e.g., K. PLEVAN & M. SIROKY, *ADVERTISING COMPLIANCE HANDBOOK* 363-92 (1988); Jordan & Rubin, *supra* note 13, at 536.

18. Note, *supra* note 16, at 893.

that the allegedly disparaging claims were false and malicious.<sup>19</sup> Defamation was somewhat easier to prove because malice and proof of financial damage were not required and because the defendant had the burden of proving the truth of its statements. However, injunctions typically were not granted for defamation.<sup>20</sup> Moreover, the plaintiff had to prove that the challenged statements impugned the integrity or character of the business.<sup>21</sup>

"Passing off" cases were most likely to obtain injunctive relief. Damages were also available, if damages could be proven. Jordan and Rubin argue that the relative ease in proving "passing off" and defamation over disparagement was justified by the fact that consumers could evaluate the disparagement claims through product examination or use, but could not readily evaluate the truth of a claim about a firm's identity or integrity (*e.g.*, that its owners are devil worshipers).<sup>22</sup>

Jordan and Rubin's simple analysis supports their belief that limited common-law relief is sufficient and that neither FTC nor Lanham Act advertising regulation is needed for the protection of consumers.<sup>23</sup> There are a number of flaws in their argument. For purposes of this analysis, Jordan and Rubin's implicit adoption of consumer injury as the appropriate criterion for judging the regulation of false advertising is adopted. As noted above, this criterion is consistent with both the FTC and the Lanham Act.<sup>24</sup>

First, Jordan and Rubin's argument is based upon their belief that most product attributes of interest to consumers can be readily judged by consumers either before or after purchase. However, growing use of mail and telemarketing techniques mean that consumers cannot examine goods before purchase and may be deceived into purchase even regarding search attributes (*i.e.*, attributes consumers can judge upon product examination) by "fly-by-night" operators.<sup>25</sup> Moreover, comparative advertising about search attributes is more difficult for consumers to verify if the consumer must visit several dealers to examine all of the goods compared. In either case, individual consumer injury may be too small to justify consumer lawsuits, particularly against a business located in a

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19. *Id.*

20. *Id.*

21. *Id.* at 893-94.

22. Jordan & Rubin, *supra* note 13, at 536-37.

23. *Id.* at 541-42, 545-49, 551-53.

24. See *supra* notes 11-12 and accompanying text.

25. See Reich, *Toward a New Consumer Protection*, 128 U. PA. L. REV. 1, 39-40 (1979). Cf. Pitofsky, *Beyond Nader: Consumer Protection and the Regulation of Advertising*, 90 HARV. L. REV. 661, 687 (1977) (deceptive price advertising might deceive consumers into making purchases, but consumers can often check the validity of such claims).

distant state.<sup>26</sup> However, the magnitude of aggregate consumer injury may be sufficiently large to justify a government or a competitor lawsuit.

Second, Jordan and Rubin ignore the role of product price and frequency of purchase in determining the amount of consumer injury. They assume that for experience attributes (*i.e.*, those that can only be evaluated after purchase), consumers may be deceived into a single purchase, but injury will be minimal. However, if the goods are infrequently purchased and evaluation takes a long time, businesses have stronger incentives to advertise falsely. Goods with these characteristics are frequently expensive; therefore, additional consumer protection may be cost justified. Of course, if the price of such goods is sufficiently high and consumers can prove that the advertising claims became part of the bargain and therefore constitute an express warranty, consumers may have the incentive to sue for breach of warranty.<sup>27</sup> This is particularly true when attorneys can form a large class of consumers as plaintiffs.<sup>28</sup>

Third, with the exception of producer identity and integrity, Jordan and Rubin ignore credence attributes — attributes that consumers cannot readily verify. Advertising involving claims concerning credence characteristics have great potential for being false without additional regulation.

It is useful to divide credence attributes into two categories. Some attributes cannot be accurately evaluated through product use, but consumers may get some sense of such claims' truthfulness over time even without being able to perform a precise evaluation. Examples of such attributes include claims concerning joint inputs when all of the inputs contribute to performance, health claims for foods, and claims for drugs in which the placebo effect may cause consumers to believe the product works better than it does.

The second category of credence attributes are those that the consumer cannot evaluate through product use. These may be called faith attributes. Examples include manufacturer identity, geographic origin, certification as union made, exclusivity claims such that a product is patented, and many content claims (*e.g.*, that a food contains a specified amount of a nutrient). Advertising about faith or credence characteristics or about experience claims for expensive, durable products have the greatest potential for being false and provide the strongest justification for regulation beyond

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26. Jordan & Rubin, *supra* note 13, at 545.

27. For a recent discussion of consumer suits for breach of express warranties based on advertising claims, see Lewis, *Toward a Theory of Strict "Claim" Liability: Warranty Relief for Advertising Representations*, 47 OHIO ST. L.J. 671 (1986).

28. See Moewe, *Consumers, Class Actions and Costs: An Economic Perspective on Deceptive Advertising*, 18 U.C.L.A. L. REV. 592 (1971) (Supreme Court has held that injury of individual consumers cannot be aggregated to satisfy the \$10,000 diversity jurisdiction requirement).

the common law. Thus, there appears to be a need for additional control of false advertising beyond that provided by the common law. The next section examines FTC regulation and Lanham Act competitor lawsuit regulation to explore the similarities and differences from a public policy perspective.

### *B. Public versus Private Regulation*

No one really knows what motivates regulatory agencies.<sup>29</sup> The theory of public interest regulation assumes that the FTC seeks to bring cases in which the estimated consumer injury is greater than the expected cost of the proceeding. Given an unlimited budget, the FTC would place all potential cases in order of net benefit and bring all of the cases in which the net benefit, as measured by future injury prevented, equals the expected cost of proceeding. With a limited budget, the FTC should choose those cases with the maximum net benefit. The FTC should look at past consumer injury when seeking refunds and future injury when seeking injunctive relief. The FTC may also include some deterrent benefit by attacking a particular industry or practice anticipating that others will "get the message" without the necessity of additional formal proceedings.

The expected costs of formal proceedings include the probability of settlement times the cost of proceeding until settlement summed for all possible settlements (including no settlement, an appeal to a court of appeals, and possibly an appeal to the United States Supreme Court). If the Commission challenges explicit claims that are readily established by examining the ads, its costs are lower than when it challenges implicit ads in which there likely will be conflicting evidence of consumer interpretation. Similarly, if the claims are challenged as being unsubstantiated, the FTC need only prove the inadequacy of the purported substantiation, rather than incurring the additional cost of proving that the claims are false. Lastly, the toughness of the desired order (refunds, disclosures, scope of products, and types of claims covered) will affect the willingness of the respondent to settle.

For Lanham Act competitor plaintiffs, the cost-benefit calculus is different. The plaintiff probably has lower costs than the FTC for monitoring product claims because of its familiarity with products in its industry. The plaintiff may even have lower costs of proving claims false

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29. For a survey of articles discussing economic theories of regulation, see McCormick, *The Strategic Use of Regulation: A Review of the Literature*, in THE POLITICAL ECONOMY OF REGULATION: PRIVATE INTERESTS IN THE REGULATORY PROCESS 13, 17-24 (1986) (1984 F.T.C. Law and Economics Conference); Noll, *Government Regulatory Behavior: A Multidisciplinary Survey and Synthesis*, in REGULATORY POLICY AND THE SOCIAL SCIENCES (R. Noll ed. 1985).

if it already has conducted tests or has low costs for doing so because of its in-house product expertise.

The plaintiff may also have lower benefits than the FTC because it looks at the injury to its own sales and profits, rather than total consumer injury. Competitor injury may differ from consumer injury as defined by the FTC. For example, the FTC may have little interest in protecting consumers from advertising that misleads them into trying a disposable product. If consumers are dissatisfied with a product, they can decide not to repurchase. Businesses, on the other hand, may litigate over such advertising for fear that consumers, once they try the new product, will not switch back because they prefer the new product (despite its misleading advertising) or simply because of inertia. For these reasons, plaintiffs are more likely to have a large market share. Also, they are likely not to sue extremely small, marginal companies, but will sue firms of a significant size, especially if these firms have the perceived ability to grow significantly. Plaintiffs may sue marginal firms if they wish to establish a reputation of deterring aggressive competition. In addition, a smaller "number two" firm in an industry may sue a larger firm if it perceives that most of the gains of suing will flow to it, rather than other, even smaller, competitors.<sup>30</sup> Such a lawsuit may be less expensive than attempting counter-advertising at a level sufficient to match the larger rival. The suit may also gain publicity at no additional cost.

Explicit comparative advertising is more likely to be challenged if the plaintiff believes such rival advertising could diminish its sales more than noncomparative advertising that merely extols the virtues of the rival product. One other benefit for the plaintiff to consider in bringing suit is the ability to discover its rival's strategy, to depose the rival's top executives to gain information, or simply to harass the rival into ceasing the advertising before a decision is reached by the court.

When evaluating the costs of the suit, the Lanham Act plaintiff will consider the probable speed of obtaining a preliminary injunction and the high costs and low probability of successfully proving damages. A large plaintiff may have more resources or greater sales over which to spread the costs of the suit than a smaller rival. The plaintiff should recognize that this increases the probability of a favorable settlement that would require the rival to develop new advertising.

Imposing differentially higher unit costs on rivals has generated much antitrust commentary.<sup>31</sup> Such a suit can be anticompetitive and can be

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30. See *MCI and AT&T to See Each Other in Court Again*, Washington Post, Oct. 11, 1989, at F1 (MCI suing AT&T under the Lanham Act for false advertising).

31. See Salop & Scheffman, *Raising Rivals' Costs*, 73 AM. ECON. REV. 267 (1983). For a more extensive treatment, see Krattenmaker & Salop, *Raising Rivals' Costs*, 96 YALE L.J. 209 (1986). For an opposing view see Brennan, *Understanding Raising Rivals' Costs*, 33 ANTITRUST BULL. 95 (1988).

challenged under the antitrust laws as "sham" litigation if it truly lacks a legitimate basis and the plaintiff has the requisite market power.<sup>32</sup> Indeed, many commentators suggest that competitor lawsuits may be anticompetitive and may not promote the public interest.<sup>33</sup> In 1977, the Supreme Court recognized that competitors might sue under the antitrust laws to redress an injury to them that occurred because of increased, rather than decreased, competition.<sup>34</sup> The Court denied recovery to such plaintiffs unless they could show "antitrust injury" — injury that reflects "the anticompetitive effect . . . of the violation."<sup>35</sup>

Fortunately, from a public policy perspective, there is little reason to believe that Lanham Act lawsuits can be used to actually monopolize an industry. The typical injunction remedy only prohibits specific claims, leaving the advertiser free to make slightly modified claims.<sup>36</sup> Unlike antitrust cases, multiple damage awards that might bankrupt a rival are rarely awarded.<sup>37</sup> Moreover, unlike the import relief laws, a Lanham Act injunction does not constitute a significant barrier to market entry.<sup>38</sup> Of course, the Lanham Act can be used to harass small rivals in order to signal them to reduce their competitive efforts (for example, to stop making explicit comparisons) or to face the expensive consequences of defending, and possibly losing, a lawsuit. Thus, there is some potential for anticompetitive misuse of private advertising litigation.

## II. LEGAL COMPARISON

### A. Federal Trade Commission

The FTC was established in 1914 as an independent regulatory agency empowered to create and enforce emerging antitrust policy. The FTC's

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32. For an excellent exposition on this subject, see Hurwitz, *Abuse of Governmental Processes, The First Amendment, and the Boundaries of "Noerr,"* 74 GEO. L.J. 601 (1985). Hurwitz identifies three legal formulations of "sham" litigation as an antitrust claim: (1) a pattern of baseless claims; (2) claims that lack a reasonable basis in fact or law; and (3) litigation that is not cost-justified. For an example, see *Wilkinson to Gillette: En Garde*, Boston Herald, June 21, 1989, at 29 (Wilkinson filed a counterclaim in Gillette's Lanham Act suit alleging Gillette's advertising challenges were monopolistic).

33. See R. BORK, THE ANTITRUST PARADOX: A POLICY AT WAR WITH ITSELF 347-64 (1978); C. KLEIN, ECONOMICS OF SHAM LITIGATION: THEORY, CASES AND POLICY (1989) (Bureau of Economics Staff Report to the Federal Trade Commission); Baumol & Ordover, *Use of Antitrust to Subvert Competition*, 27 J.L. & ECON. 247 (1985).

34. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477 (1977).

35. *Id.* at 489.

36. See *infra* note 121 and accompanying text.

37. See, e.g., Baumol & Ordover, *supra* note 33, at 252-54.

38. See Calvani & Tritell, *Invocation of United States Import Relief Laws as an Antitrust Violation*, 16 J. REPRINTS ANTITRUST L. & ECON. 475 (1985); Waller, *Abusing the Trade Laws: An Antitrust Perspective*, 17 L. & POL. IN INT'L BUS. 487 (1985).

task was to condemn "unfair methods of competition."<sup>39</sup> From its beginning, it pursued false advertising cases.<sup>40</sup> However, after the Supreme Court held that the FTC must prove injury to competition in advertising cases, the FTC obtained authority to pursue unfair or deceptive acts and practices in 1983.<sup>41</sup> Under this authority, the FTC regulates virtually all types of advertising.<sup>42</sup> It now uses that authority to condemn advertising that is likely to harm consumers and no longer expressly considers harm to competitors.<sup>43</sup>

FTC advertising cases follow a three step process. First, the Commission "interprets" the advertisements to determine what claims a reasonable consumer would find. Second, it decides whether those claims are deceptive or unsubstantiated. Third, it determines an appropriate remedy. Occasionally, the FTC also pursues advertising that it deems to be unfair.<sup>44</sup> Each of these steps will be addressed in turn.

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39. Act of Sept. 26, 1914, ch. 311, § 45(a)(1), 38 Stat. 717, 719.

40. See, e.g., *FTC v. Winsted Hosiery Co.*, 258 U.S. 483 (1922); *Sears, Roebuck & Co. v. FTC*, 258 F. 307, 311 (7th Cir. 1919).

41. *FTC v. Raladam Co.*, 283 U.S. 643, 649 (1931). See also Pub. L. No. 75-447, § 3, 52 Stat. 111, 111 (1938) (codified at 15 U.S.C. § 45(a)(1) (1982)).

42. Other federal agencies may exercise jurisdiction over the advertising of certain products. For example, the Bureau of Alcohol, Tobacco, and Firearms regulates the advertising of alcoholic beverages as do several states under the twenty-first amendment. The Food and Drug Administration regulates the labeling of over-the-counter pharmaceuticals and the advertising and labeling of prescription drugs. In addition, the U.S. Postal Service can pursue companies for mail and wire fraud. See, e.g., *United States v. Alexander*, 743 F.2d 472 (7th Cir. 1984) (seller advertised low prices, but failed to deliver); *United States v. Andreadis*, 366 F.2d 423 (2nd. Cir. 1966), cert. denied, 385 U.S. 1001 (1967) (claim of weight loss without dieting was untrue). Lastly, states are increasingly seeking to regulate advertising. All 50 states have "miniature" FTC acts and several have other advertising statutes. K. PLEVAN & M. SIROKY, *supra* note 17, at 343, 351. See also *People v. Western Airlines*, 155 Cal. App. 3d 597, 202 Cal. Rptr. 237 (1984) (California deceptive advertising statute applies to airlines); Beales, *What State Regulators Can Learn from Federal Experience in Regulating Advertising*, 10 J. PUB. POL. & MKTG. 101 (1991); Calvani, *Advertising Regulation: The States vs. The FTC*, 58 ANTITRUST L. J. 253 (1989); Richards, *FTC or NAAG, Consumers or Advertisers: Who Will Win the Territorial Battle?* 10 J. PUB. POL. & MKTG. 118 (1991); *Beef Trade Forced to Alter Ads*, N.Y. Times, March 2, 1985, at 48, col. 1 ("For the fifth time in less than two years . . . the New York State Attorney General has been responsible for significant changes in a national advertising campaign.").

43. In fact, the FTC has the discretion to refuse to pursue cases that competitors may bring to its attention. See, e.g., *Moog Indus. v. FTC*, 355 U.S. 411 (1958) (FTC discretion to set enforcement priorities); *Exposition Press, Inc. v. FTC*, 295 F.2d 869, 873-74 (2d. Cir. 1961) (deference to FTC expertise in deciding public significance of enforcement actions).

44. Under the FTC's unfairness jurisdiction and recent policy statement, prepared under the guidance of Michael Pertschuk, Chairman under President Carter, it would pursue advertising claims as unfair if they are likely to cause substantial consumer injury

*1. Interpreting the Ads.*—The FTC acts in advertising cases first by interpreting the ads to determine what claims are being made. It is authorized to use its own expertise to determine both the express and implied claims made in the advertisement.<sup>45</sup> It often uses evidence of consumer perceptions of the ads to make this determination.<sup>46</sup> The FTC next determines whether the claims are deceptive or unsubstantiated.

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as determined by the conduct's net effects and consumers could not reasonably avoid such injury. Thus, in a situation in which the omission of product information might harm consumers, the FTC will require the disclosure of this information in advertising when the costs to the advertiser, and ultimately purchasers, of doing so, do not outweigh the benefits. Additionally, consumers must not readily be able to determine the missing information by a simple examination of the product. Of course in many cases, the omission of such information might also be deceptive. For a brief explanation of the FTC's recent deception, unfairness, and advertising substantiation policy statements, see Crawford, *Unfairness and Deception Policy at the FTC: Clarifying The Commission's Roles and Rules*, 54 ANTITRUST L.J. 305 (1985). The Commission's Unfairness Policy Statement is appended to its decision in International Harvester, 104 F.T.C. 949, 1072 (1984). See also Averitt, *The Meaning of "Unfair Acts or Practices" In Section 5 of the Federal Trade Commission Act*, 70 GEO. L.J. 225 (1981).

The only examples of advertising the FTC has challenged solely on unfairness grounds involve depictions of unsafe behavior that children viewing the advertisements might emulate. See, e.g., Universal Body Bldg., 96 F.T.C. 783 (1980) (consent order prohibiting promotion of bodybuilding to children until safety study completed); A.M.F., Inc., 95 F.T.C. 310 (1980) (consent order prohibiting bicycle advertisements showing unsafe riding); Mego Int'l, 92 F.T.C. 186 (1978) (consent order prohibiting depictions of young children using electrical appliances); Uncle Ben's Inc., 89 F.T.C. 131 (1977) (consent order prohibiting depictions of unsupervised children near active gas stove); General Foods Corp., 86 F.T.C. 831 (1975) (consent order prohibiting depiction of naturalist eating wild nuts and berries); Philip Morris, Inc., 82 F.T.C. 16 (1973) (consent order prohibiting placement of sample of razor blades in newspapers where they might injure children).

Advertising that lacks a reasonable basis was once challenged as both deceptive and unfair. See, e.g., Pfizer, 81 F.T.C. 23 (1972). In 1984, however, the Commission stopped pleading unfairness in such cases. See P. Leiner Nutritional Prods. Corp., 105 F.T.C. 291 (1985).

45. See, e.g., *FTC v. Colgate*, 380 U.S. 374, 391 (1965); *J.B. Williams Co. v. FTC*, 381 F.2d 884, 886 (6th Cir. 1967); *Zenith v. FTC*, 143 F.2d 29, 31 (7th Cir. 1944).

46. A study of 3,337 FTC cases from 1914 through 1973 found that only 206 involved any evidence of consumer perception. Most of those were consumer testimony with only 12 cases containing surveys of consumers' perceptions. Extrinsic evidence was used in only 6.8% of all cases from 1919-1954, but was used in 32.8% of the cases decided during 1955-1973. Brandt & Preston, *The Federal Trade Commission's Use of Evidence to Determine Deception*, 41 J. MKTG. 54 (1977). From 1973 through 1984, extrinsic evidence was used in 10 of 23 litigated cases (43%). Preston, *Data-Free at the FTC? How the Federal Trade Commission Decides Whether Extrinsic Evidence of Deceptiveness is Required*, 24 AM. BUS. L.J. 359, 361 (1986). From 1985 through 1989 only two of eight litigated cases (25%) examined extrinsic evidence of consumer perception. Preston, *The Definition of Deceptiveness in Advertising and Other Commercial Speech*, 39 CATH. U. L. REV. 1035, 1050 n.50 (1990) [hereinafter Preston, *Deceptiveness*] (Preston examined a ninth case, Int'l Harvester, 104 F.T.C. 949 (1984)). This last case is excluded here because it did not allege misleading advertising.

2. *Are the Ads Misleading?*—Under the FTC's recent Deception Policy Statement, an advertisement is considered to be deceptive if it contains a representation, practice, or omission likely to mislead consumers acting reasonably and if the representation, practice, or omission is material to consumer choice.<sup>47</sup> As applied, this Statement appears to make three changes in prior law.<sup>48</sup>

First, prior law required only that the act or practice have the tendency or capacity to mislead consumers.<sup>49</sup> The Deception Policy Statement, however, requires the act or practice to be likely to mislead. This change requires the Commission to prove a probability of deception, not a mere possibility;<sup>50</sup> however, it does not require proof of actual deception.<sup>51</sup>

Second, the Deception Policy Statement adopts an objective standard, similar to that used in tort law, of a reasonable consumer.<sup>52</sup> Past cases generally held that the Commission must find that a substantial number of people within the audience may be misled.<sup>53</sup> Occasional cases go further to indicate that "the ignorant, the unthinking and the credulous" are protected.<sup>54</sup> Other cases have limited this concept to reasonable interpretations of the advertising.<sup>55</sup>

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47. Deception Policy Statement, appended to *In re Cliffdale Associates*, 103 F.T.C. 110, 174-84 (1984) [hereinafter Deception Policy Statement]. Its use by the FTC was upheld by the Ninth Circuit in *Southwest Sunsites v. FTC*, 785 F.2d 1431, 1435 (9th Cir. 1986).

48. After sending the Deception Policy Statement to Congress, it was criticized as being a change in the law. Chairman Dingell of the congressional committee that requested the analysis of the existing law of deception rejected the Statement as being a statement of what some thought the law should be. Chairman Miller defended it as not being a change in the existing law. However, as argued below, it is clear that it was a change. See Bailey & Pertschuk, *The Law of Deception: The Past as Prologue*, 33 AM. U.L. REV. 849, 851-54 (1983); Karns, *The Federal Trade Commission's Evolving Deception Policy*, 22 U. RICH. L. REV. 399, 402 (1988).

49. See *Sears, Roebuck & Co. v. FTC*, 258 F. 307, 311 (7th Cir. 1919); *Cole-Conrad Co.*, 2 F.T.C. 188, 192-93 (1919); *Gordon-Van Tine Co.*, 1 F.T.C. 316, 323 (1919) ("do unfairly tend to, and do, deceive"); *E.P. Janes*, 1 F.T.C. 380, 385 (1919) ("tendency to mislead"); Bailey & Pertschuk, *supra* note 48, at 871.

50. J. RICHARDS, DECEPTIVE ADVERTISING: BEHAVIORAL STUDY OF A LEGAL CONCEPT 15 (1990).

51. See *In re Cliffdale Associates*, 103 F.T.C. 110, 165 (1984). Accord *Trans World Accounts, Inc. v. FTC*, 594 F.2d 212, 214 (9th Cir. 1979); *Resort Car Rental System, Inc. v. FTC*, 518 F.2d 962, 964 (9th Cir.), cert. denied, 423 U.S. 827 (1975).

52. RESTATEMENT (SECOND) OF TORTS §§ 282-83 (1965).

53. See, e.g., *Bristol-Myers Co. v. FTC*, 85 F.T.C. 688, 744 (1975); Bailey & Pertschuk, *supra* note 48, at 883-92; Karns, *supra* note 48, at 405.

54. See, e.g., *FTC v. Standard Educ. Soc'y*, 302 U.S. 112, 116 (1937); *Exposition Press, Inc. v. FTC*, 295 F.2d 869, 872 (2nd Cir. 1961); *Aronberg v. FTC*, 132 F.2d 165, 167 (7th Cir. 1943).

55. See *Heinz W. Kirchner*, 63 F.T.C. 1282, 1290 (1963), aff'd, 337 F.2d 751 (9th Cir. 1964) (Commission declined to interpret ad as it would be understood by an "insignificant and unrepresentative" group of consumers).

Under the former substantial numbers standard, the Commission never defined what is a substantial number. Bailey and Pertschuk suggest that twenty to twenty-five percent of the audience is substantial, but would allow a smaller percentage if the potential consumer injury is large.<sup>56</sup> Two decisions by circuit courts, affirming FTC opinions in which survey evidence was rejected, have expressed approval for numbers lower than the fifteen percent level.<sup>57</sup> In *Benrus Watch v. FTC*,<sup>58</sup> the court held that fourteen percent constitutes a "percentage that is entitled to protection."<sup>59</sup> In *Firestone Tire & Rubber Co. v. FTC*,<sup>60</sup> the court stated that it is "hard to overturn the deception findings of the Commission if the ad thus misled ten or fifteen percent of the buying public."<sup>61</sup>

The replacement of the substantial number standard with the reasonable consumer standard appears to make it harder to prove deception.<sup>62</sup> The modern standard provides room for argument that despite any evidence of the deception of substantial numbers of consumers, those consumers were not behaving reasonably. The present standard appears more arbitrary than the substantial numbers standard and probably adds uncertainty to enforcement initiatives.

Although the Deception Policy Statement states that omissions are possibly deceptive, its application in conjunction with the Unfairness Policy Statement arguably has changed prior law.<sup>63</sup> In *In re International Harvester*,<sup>64</sup> the Commission majority created the so-called "pure omission" — silence on a subject in circumstances that do not give any particular meaning to the silence.<sup>65</sup> The "pure omission" can be pursued only under the unfairness doctrine.<sup>66</sup> In order for an omission to be deceptive, the majority stated that it must be in the context of a "half truth" or have occurred under other circumstances in which silence constitutes an implied misrepresentation.<sup>67</sup> The majority recognized the concept of reasonable fitness for intended use that requires products to be free of "gross" safety hazards, but did not apply it to the "fuel gysering" problem at issue

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56. Bailey & Pertschuk, *supra* note 48, at 890-91.

57. See also Preston & Richards, *Consumer Miscomprehension as a Challenge to FTC Prosecutions of Deceptive Advertising*, 19 J. MARSHALL L. REV. 605, 610-13 (1986).

58. 352 F.2d 313 (8th Cir. 1965), cert. denied, 384 U.S. 939 (1966).

59. *Id.* at 319-20.

60. 481 F.2d 246 (6th Cir.), cert. denied, 414 U.S. 1112 (1973).

61. *Id.* at 249.

62. See Karns, *supra* note 48, at 407-13.

63. For a discussion of the Unfairness Policy Statement and the application of unfairness to advertising, see *supra* note 44.

64. 104 F.T.C. 949 (1984).

65. *Id.* at 1050-51, 1059.

66. *Id.*

67. *Id.* at 1057-58

because only twelve of 1.3 million tractors were known to have this problem.<sup>68</sup> In her dissent, Commissioner Bailey rejected the majority view that this omission was not deceptive. She maintained that manufacturers must point out nonobvious safety hazards or they are deceiving consumers into believing that the product is reasonably safe.<sup>69</sup>

3. *Substantiation.*—The second prong of FTC advertising regulation includes a requirement that advertisers must have a “reasonable basis” for their advertising claims prior to making them.<sup>70</sup> In 1984, after a thorough review of the program, the FTC issued its Policy Statement Regarding Advertising Substantiation.<sup>71</sup> Although Chairman Miller previously expressed reservations about the program,<sup>72</sup> the Statement reaffirms this requirement and suggests only minor clarification.

The substantiation requirement appears simple, but deceptively so. Advertisers must have a “reasonable basis” for their express and implied advertising claims. Like the “reasonable person” standard in tort law, this standard is objective, not subjective, and is judged on a case-by-case basis.<sup>73</sup> According to the Substantiation Policy Statement, claims that promise a certain level of substantiation (e.g., “tests prove”), must be supported by that level of substantiation. Claims that imply a high level of substantiation to reasonable consumers must have the promised level of substantiation.<sup>74</sup> For example, comparative claims, specific performance

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68. *Id.* at 1058-59, 1063. The Deception Policy Statement expressly recognizes the concept of reasonable fitness for intended use, but makes no mention of “gross” safety defects: “the practice of offering a product for sale creates an implied representation that it is fit for the purpose for which it is sold. Failure to disclose that the product is not fit constitutes a deceptive omission.” Deception Policy Statement, *supra* note 47, at 175 n.4.

69. *In re Int'l Harvester*, 104 F.T.C. 949, 1078 (1984) (Bailey, Comm'r, dissenting); Deception Statement, *supra* note 47, at 175 n.4.

70. Pfizer, Inc., 81 F.T.C. 23, 64 (1972). However, while announcing this new doctrine, the Commission did not find Pfizer liable, so there was no basis for an appeal. *Id.* See also National Dynamics Corp., 82 F.T.C. 488 (1973), *petition denied*, 492 F.2d 1333 (2d Cir. 1974), *cert. denied*, 419 U.S. 993 (1974); Firestone Tire & Rubber Co., 81 F.T.C. 398 (1972), *aff'd*, 481 F.2d 246 (6th Cir.), *cert. denied*, 414 U.S. 1112 (1973). For earlier precedents for substantiation, see Shafer, *Developing Rational Standards for an Advertising Substantiation Policy*, 55 U. CIN. L. REV. 1, 5-13 (1986).

71. See FTC Policy Statement Regarding Advertising Substantiation, appended to *In re Thompson Medical Co.*, 104 F.T.C. 648, 839-42 (1984) [hereinafter Substantiation Policy Statement].

72. See Karns, *supra* note 48, at 401, 406-07.

73. Although the Pfizer decision refers to the “reasonable and prudent businessman, acting in good faith,” it also states, “The standard depends on both those facts known to the advertiser, and those which a reasonable prudent advertiser should have discovered.” *Pfizer*, 81 F.T.C. at 64.

74. Substantiation Policy Statement, *supra* note 71, at 840.

claims, and claims with a scientific aura, imply that tests were performed to substantiate them. The Statement also lists six factors, commonly referred to as the *Pfizer* factors (although the *Pfizer* decision lists only five), that the FTC considers when determining what a reasonable level of substantiation should be in a specific case. These factors are: (1) type of claim; (2) type of product; (3) consequences of a false claim; (4) benefits of a truthful claim; (5) cost of developing substantiation; and (6) the amount experts feel is reasonable.<sup>75</sup>

Finally, Commission law requires that the substantiation be developed prior to the dissemination of the advertising claims. However, for the first time, the Substantiation Statement suggests flexibility in this rule by listing four circumstances when the FTC will consider post-claim evidence of truthfulness: (1) when deciding whether it is in the public interest to proceed against an advertiser; (2) when evaluating the truth of a claim; (3) when determining the reasonableness of proffered prior substantiation; or (4) when considering the appropriate scope of a remedial order.<sup>76</sup>

The other nuance in the Statement is the cessation of "industry-wide" rounds of publicized requests for substantiation from all members of a particular industry.<sup>77</sup> However, this nuance is of minor significance because the use of these rounds had been declining since 1975 and none were conducted after 1980.<sup>78</sup> At least one commentator has argued that these rounds were useful in establishing the FTC's presence in regulating national advertising.<sup>79</sup> Thus, unlike the controversial Deception Policy Statement that changed prior law, the Substantiation Statement confirmed prior law, but renounced the burden of industry-wide inquiries and added some flexibility to consider post-claim substantiation.

There is some evidence, however, that a "reasonable basis" for at least some Reagan-appointed commissioners was less stringent than for their predecessors. Prior to 1980, the normal substantiation requirement for advertising claims involving drugs and medical devices was two clinical studies.<sup>80</sup> Yet, in two cases involving electric shavers marketed to black men as a treatment for "razor bumps," the Commission voted to reconsider

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75. *Id.* See also *In re Thompson Medical Co.*, 104 F.T.C. 648, 821 (1984), *aff'd*, 791 F.2d 189 (D.C. Cir. 1986), *cert. denied*, 419 U.S. 1096 (1987).

76. Substantiation Policy Statement, *supra* note 71, at 840-41.

77. *Id.* at 647.

78. See Bureau of Consumer Protection, Advertising Substantiation Program: Analysis of Public Comments and Recommended Changes 14-15 (Mar. 1984).

79. See *Federal Trade Commission 75th Anniversary Symposium*, 58 ANTITRUST L. J. 797, 819 (1990) [hereinafter *FTC Anniversary Symposium*] (Statement of Mr. Rosch: "It gave notice that the cop was really on the beat.").

80. See K. PLEVAN & M. SIROKY, *supra* note 17, at 199-210.

the two clinical test requirements of the consent orders.<sup>81</sup> Ultimately, the Commission decided not to change the orders.<sup>82</sup>

More recently, in *Removatron International Corp.*,<sup>83</sup> a four member Commission could not agree whether to affirm the administrative law judge's order requiring two clinical studies to substantiate claims of permanent hair removal by a medical device.<sup>84</sup> They ultimately crafted an ambiguous order that simply required scientific evidence.<sup>85</sup> Thus, the standard, once clear, is now in question.

4. *Remedies.*—As this discussion of the reasonable basis for performance claims of medical products illustrates, the final step in FTC advertising cases is the imposition of a remedial order. The standard administrative remedy in an advertising case is a simple cease and desist order. Should a company violate the order, it will be subject to civil penalties.<sup>86</sup> A cease and desist order typically prohibits claims that are false or misleading, but it also prohibits other claims until the advertiser has a reasonable basis for them. As discussed above, the type of evidence that will constitute a reasonable basis is often specified in the order.<sup>87</sup> In addition, FTC cease and desist orders are noted for their "fencing-in" provisions. For example, in a recent case concerning Sears's false advertising for its Lady Kenmore dishwashers, the FTC order covered performance claims for all major appliances.<sup>88</sup>

In some cases, the FTC has augmented its cease and desist orders with additional remedies. The FTC has ordered that future advertising

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81. North Am. Phillips Corp., 101 F.T.C. 359 (1983); Sperry Corp., 98 F.T.C. 4 (1981).

82. Sperry Corp., 104 F.T.C. 549 (1984).

83. No. 9200, slip op. (F.T.C. Nov. 4, 1988), *aff'd and injunction issued*, 884 F.2d 1489 (1st Cir. 1989). See also Adria Labs., Inc., 103 F.T.C. 512, 526 (1984).

84. *Removatron*, No. 9200, slip op. at 26.

85. *Id.*

86. See 15 U.S.C. § 45(l),(m) (1988). See also United States v. J.B. Williams Co., 354 F. Supp. 521 (S.D.N.Y. 1973), modified, 498 F.2d 414 (2d Cir. 1974) (affirming penalties against J.B. Williams of \$456,000, but modifying penalties against Parkson Advertising Agency of \$356,000).

87. See *supra* notes 81-85 and accompanying text.

88. Sears, Roebuck & Co. v. FTC, 676 F.2d 385, 392-94 (9th Cir. 1982). See also American Home Prods. Corp. v. FTC, 695 F.2d 681, 706-08 (3d Cir. 1982) (order covered all over-the-counter drugs based on liability for Anacin advertising); Litton Indus., Inc. v. FTC, 676 F.2d 364, 371-72 (9th Cir. 1982) (order covering all consumer products based on microwave advertising); Porter & Dietsch, Inc. v. FTC, 605 F.2d 294, 305 (7th Cir. 1979), cert. denied, 445 U.S. 950 (1980) (order covering any food, drug, cosmetic, or device based on advertising for diet aids); ITT Continental Baking Co. v. FTC, 532 F.2d 207, 222-23 (2d Cir. 1976) (order covering all food products based on advertising for Wonder Bread).

disclose specified information to prevent future deception.<sup>89</sup> Often the disclosure is "triggered" by the making of certain advertising claims. Occasionally, the Commission has ordered corrective advertising disclosures to remedy the "lingering beliefs" in the minds of consumers created from past false advertising.<sup>90</sup>

The FTC has also obtained consumer refunds. Two parts of the Federal Trade Commission Act authorize this relief. Section 19 of the Federal Trade Commission Act authorizes the Commission to seek consumer redress for "knowingly dishonest or fraudulent conduct" after completion of an administrative proceeding and the issuance of a cease and desist order.<sup>91</sup> The Trans-Alaska Oil Pipeline Authorization Act of 1973 added section 13(b) to the FTC Act authorizing the Commission to obtain both preliminary and permanent injunctions in federal court.<sup>92</sup> The FTC has used this authority to seek federal court injunctions to obtain refunds or an asset freeze so money will be available for refunds if the court believes they are warranted.

### B. *Lanham Act*

A Lanham Act plaintiff must prove that the false statements either have deceived or have the capacity to deceive a substantial segment of the audience, that the deception is material to the purchasing decision, and that the plaintiff is injured or likely to be injured by the statement.<sup>93</sup> Like the FTC, the process begins with interpreting the ads.

1. *Interpreting the Advertisements.*—Many judges ease the plaintiff's burden by interpreting the meaning of the express claims within the

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89. See Pitofsky, *supra* note 25, at 661-71.

90. See, e.g., *Warner-Lambert Co. v. FTC*, 562 F.2d 749 (D.C. Cir. 1977), *cert. denied*, 435 U.S. 950 (1978); Pitofsky, *supra* note 25, at 694-701.

91. 15 U.S.C. § 57b (1988).

92. Trans-Alaska Oil Pipeline Authorization Act, Pub. L. No. 93-153, § 408(f), 87 Stat. 592 (1973) (codified at 15 U.S.C. § 53(b)). For a discussion of cases under this section, see Cornell, *Federal Trade Commission Permanent Injunction Actions Against Unfair and Deceptive Practices: The Proper Case and the Proper Proof*, 61 ST. JOHN'S L. REV. 473 (1987); Paul, *The FTC's Increased Reliance on Section 13(b) in Court Litigation*, 57 ANTITRUST L. J. 141, 143-44 (1988).

93. *Skil Corp. v. Rockwell Int'l Corp.*, 375 F. Supp. 777, 783 (N.D. Ill. 1974). Until its amendment in 1988, § 43(a) of the Lanham Act simply provided a private right of action to any person "who believes that he is or is likely to be damaged by the use of any . . . false description or representation" in connection with any goods or services in commerce. The Trademark Law Revision Act of 1988, Pub. L. No. 100-667, tit. I, § 132, 102 Stat. 3946, expanded this language to cover "any . . . false or misleading description of fact or false or misleading representation of fact, which . . . in commercial advertising or promotion, misrepresents the nature, characteristics, qualities, or geographic origin of his or her or another person's goods, services or commercial activities."

advertisement without requiring evidence of how consumers would interpret them.<sup>94</sup> This is particularly true in cases of willful false advertising. Recently, the Second and Ninth Circuits have decided that if the false advertising was willful, they will presume actual consumer deception.<sup>95</sup>

Of course, other judges acknowledge their lack of expertise in this area and require evidence of consumer interpretation.<sup>96</sup> This lack of expertise argument is supported by occasional cases in which circuit courts interpret the express claims in advertising in ways diametrically opposed to the district court's interpretation.<sup>97</sup> Thus, the traditional rule for implied claims is to require evidence of consumer interpretation.<sup>98</sup>

When fifteen percent of the audience interprets the advertising in a deceptive way, the courts become concerned.<sup>99</sup> Under the original

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94. *Coca-Cola Co. v. Tropicana Prods., Inc.*, 690 F.2d 312, 317 (2d Cir. 1982); *American Brands, Inc., v. R.J. Reynolds Tobacco Co.*, 413 F. Supp. 1352, 1356 (S.D.N.Y. 1976).

95. See *PBX Enters., Inc. v. Audiofidelity Enters., Inc.*, 818 F.2d 266, 272 (2d Cir. 1987) (passing off); *U-Haul Int'l, Inc. v. Jartran, Inc.*, 793 F.2d 1034, 1041 (9th Cir. 1986); *Harper House, Inc. v. Thomas Nelson, Inc.*, No. 85-4225 (C.D. Cal. 1987) (LEXIS, Genfed library, Dist file), *rev'd in part on other grounds*, 889 F.2d 197 (9th Cir. 1989) (the presumption of consumer deception based on willfulness was affirmed, but the presumption of damages equalling the amount of false advertising was reversed because the advertisements were not comparative). In a misappropriation of advertising case, the Sixth Circuit seems to have approved this standard. See *Can-Am Eng'g Co. v. Henderson Glass, Inc.*, 814 F.2d 253, 257 (6th Cir. 1987).

96. *American Home Prods. Corp. v. Johnson & Johnson*, 577 F.2d 160, 172 n.27 (2d Cir. 1978); *Proctor & Gamble Co. v. Chesebrough-Pond's Inc.*, 588 F. Supp. 1082, 1094 (S.D.N.Y. 1984), *aff'd*, 747 F.2d 114 (2d Cir. 1984); *American Brands*, 413 F. Supp. at 1357.

97. *Avis Rent A Car System, Inc. v. Hertz Corp.*, 782 F.2d 381, 384-86 (2d Cir. 1986); *Information Fashion Council v. E. F. Timme & Son*, 501 F.2d 1048 (2d Cir. 1974). Cf. *Coca-Cola Co. v. Tropicana Prods. Inc.*, 690 F.2d 312 (2d Cir. 1982) (falsity on its face); *Bose Corp. v. Linear Design Labs., Inc.*, 467 F.2d 304 (2d Cir. 1972) (held three of four claims were mere "puffing").

98. *Coca-Cola Co.*, 690 F.2d at 317; *American Home Prods.*, 577 F.2d at 165; K. PLEVAN & M. SIROKY, *supra* note 17, at 5, 415-16. But see *Tambrands, Inc. v. Warner-Lambert Co.*, 673 F. Supp. 1190 (S.D.N.Y. 1987); *Cuisinarts, Inc. v. Robot-Coupe Int'l Corp.*, 509 F. Supp. 1036 (S.D.N.Y. 1981) (defendant's advertising implied claims enjoined without consumer interpretation evidence).

99. *Coca-Cola Co. v. Tropicana Prods. Inc.*, 538 F. Supp. 1091, 1096 (S.D.N.Y.), *rev'd*, 690 F.2d 312, 317 (2d Cir. 1982) (trial court finding that 15% of consumers misled is too small for liability); K. PLEVAN & M. SIROKY, *supra* note 17, at 9. Before the adoption of the reasonable consumer test in its deception policy statement, the FTC also considered the number of consumers deceived by an advertisement. See *Bailey & Pertschuk*, *supra* note 48; *Karns*, *supra* note 48, at 417-20. For examples in early FTC cases, see *Firestone Tire & Rubber Co.*, 81 F.T.C. 398, 461-62 (1972) (1.4% not deceptive, 14% is deceptive), *aff'd*, 481 F.2d 246 (6th Cir.), *cert. denied*, 414 U.S. 1112 (1973); *ITT Continental Baking Co.*, 83 F.T.C. 865 (1973) (10-14% is deceptive); *Benrus Watch Co.*, 64 F.T.C. 1018, 1032 (1964) (14% is deceptive); *Rhodes Pharmacal Co.*, 49 F.T.C. 263 (1952) (9% is deceptive).

Lanham Act language, courts have held that literally true claims may be "false" under the Act if they are misleading.<sup>100</sup> However, the courts also recognize that advertising claims may not be deemed false if they are mere "puffing" — product praise too vague to be considered misleading.<sup>101</sup>

2. *Proving Falsity.*—Once the plaintiff proves how consumers interpret the advertisements, it must establish that the claims are false or misleading. Contrary to FTC law, most courts have held that a Lanham Act plaintiff cannot simply show a lack of substantiation by the defendant and win relief.<sup>102</sup> Of course, in cases in which the advertising explicitly or implicitly promises that its claims are supported by proper evidence, the plaintiff may prove falsity by showing a lack of substantiation.<sup>103</sup> In addition, the plaintiff may use the defendant's own tests to show the falsity of particular advertising claims.<sup>104</sup> Thus, the plaintiff need not always conduct its own tests to prove falsity.

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100. See, e.g., *Avis Rent A Car*, 782 F.2d at 383-86; *American Home Prods.*, 577 F. 2d at 165-67; *Fruit of the Loom, Inc. v. Sara Lee Corp.*, 674 F. Supp. 1020 (S.D.N.Y. 1987) (claim of 38% less shrinkage than rival, although literally true, might be misleading, but not actionable).

101. See, e.g., *Koontz v. Jaffarian*, 617 F. Supp. 1108, 1115 (E.D. Va. 1985), *aff'd*, 787 F.2d 906 (4th Cir. 1986); *Marcyan v. Nissen Corp.*, 578 F. Supp. 485, 507 (N.D. Ind. 1982), *aff'd*, 725 F.2d 687 (7th Cir. 1983).

102. See, e.g., *Sandoz Pharmaceuticals Corp. v. Richardson-Vicks Inc.*, 902 F.2d 222, 227-29 (3d Cir. 1990); *Toro Co. v. Textron, Inc.*, 499 F. Supp. 241, 253 (D. Del. 1980) (plaintiff must prove actual falsity, not merely lack of substantiation). But see *John Butler Co. v. Block Drug Co.*, 620 F. Supp. 771 (D.C. Ill. 1985) (case dismissed because claims had a "justifiable basis"); *Ciba-Geigy Corp. v. Thompson Medical Co.*, 672 F. Supp. 679 (S.D.N.Y. 1985) (packaging and advertising for defendant's 17 hour appetite suppressant and plaintiff's 15 hour product enjoined until clinical studies support duration claims). For a possible exception in the Third Circuit, see *Stiffel Co. v. Westwood Lighting Group*, 658 F. Supp. 1103 (D.N.J. 1987) (following Johnson & Johnson); *Johnson & Johnson v. Quality Pure Mfg.*, 484 F. Supp. 975, 983 (D.N.J. 1979) (injunction of defendant's claim made "without a good faith basis, grounded on substantial pre-existing proof, to support it."). At least one commentator has argued that there is a new trend toward allowing lack of substantiation to constitute a violation of the Lanham Act. See also *AMF Inc. v. Brunswick Corp.*, 621 F. Supp. 456 (E.D.N.Y. 1985); Morrison, *The Emerging Burden of Proof Rule in Drug Advertising Cases*, 78 TRADEMARK REP. 551 (1988). Courts also do not hesitate to enforce settlements that require advertising substantiation to be reviewed by a third party.

103. See, e.g., *Proctor & Gamble Co. v. Chesebrough-Pond's Inc.*, 747 F.2d 114, 119 (2d Cir. 1984); *Vidal Sassoon, Inc. v. Bristol-Myers Co.*, 661 F.2d 272, 277-78 (2d Cir. 1981); *Gillette Co. v. Wilkinson Sword, Inc.*, No. 89-3586 (S.D.N.Y. July 6, 1989) (LEXIS, Genfed library, Dist file); *Upjohn Co. v. Riohom Corp.*, 641 F. Supp. 1209, 1223-24 (D. Del. 1986). But see *Sandoz Pharmaceuticals Corp. v. Richardson-Vicks, Inc.*, 902 F.2d 222, 227-29 (3d Cir. 1990) "[t]he law does not presume that consumers assume that all OTC drug advertising claims are substantiated").

104. See, e.g., *American Home Prods. Corp. v. Johnson & Johnson*, 436 F. Supp.

The lack of a general reasonable basis requirement is an important difference between the FTC and the Lanham Act. The significance of this difference is illustrated by the FTC's case against Thompson Medical Company.<sup>105</sup> In that case, the Commission challenged representations that Aspercreme: (1) contained aspirin; (2) was proven by scientific studies to be more effective than orally-ingested aspirin for arthritis; and (3) was new. It challenged claims about Aspercreme's effectiveness and mode of performance as being unsubstantiated.<sup>106</sup> Had a competitor wanted to challenge this advertising, it would have had to perform tests to prove that Aspercreme was not effective. This would be expensive and difficult. Moreover, it currently appears impossible to disprove the claim that Aspercreme works at the site of pain by penetrating the skin. Although scientists have a theory that aspirin works in the brain, they have not been able to prove it. Because the active ingredient in Aspercreme is chemically related to aspirin, it also has not been proven how (or if) it works. Therefore, a Lanham Act plaintiff could not disprove the mode of performance claim, just like Thompson Medical could not substantiate this claim in the FTC proceeding.<sup>107</sup>

A second important difference between the FTC and the Lanham Act is that the latter does not proscribe omissions of material facts.<sup>108</sup> However, the Act does reach advertisements that contain statements deemed misleading without disclosure of additional, omitted information.<sup>109</sup>

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785, 803 (S.D.N.Y. 1977), *aff'd*, 577 F.2d 160 (2d Cir. 1978) (efficacy claim proven deceptive because the weakness of the supporting evidence should have led to a weaker claim of efficacy).

105. *In re Thompson Medical Co.*, 104 F.T.C. 648 (1984), *aff'd*, 791 F.2d 189 (D.C. Cir. 1986), *cert. denied*, 419 U.S. 1096 (1987).

106. *Id.* at 786-87.

107. *See id.* at 755-760.

108. *See, e.g.*, *Alfred Dunhill Ltd. v. Interstate Cigar Co.*, 499 F.2d 232, 237 (2d Cir. 1974); *International Paint Co. v. Grow Group, Inc.*, 648 F. Supp. 729, 730 (S.D.N.Y. 1986); *McNeilab, Inc. v. American Home Prods. Corp.*, 501 F. Supp. 517, 532 (S.D.N.Y. 1980). *But see Bohsei Enter. Co. v. Porteous Fastener Co.*, 441 F. Supp. 162 (C.D. Cal. 1977) (holding that omission of foreign origin is material); *Universal City Studios v. Sony Corp. of Am.*, 429 F. Supp. 407 (C.D. Cal. 1977) (failure to disclose possible illegality of VCR use not actionable); *In re Certain Caulking Guns*, 223 U.S.P.Q. (BNA) 388 (Int'l Trade Comm'n 1984) (omission of country of origin is a tacit misrepresentation the goods are domestic). The United States Trademark Association recommended that § 43(a) be amended to prohibit omissions of material information, but that language was deleted from the Trademark Law Revision Act of 1988. *See C. MCKENNEY & G. LONG, FEDERAL UNFAIR COMPETITION: LANHAM ACT* § 43 B-7 (1989).

109. *See, e.g.*, *Ragold, Inc. v. Ferrero, U.S.A., Inc.*, 506 F. Supp. 117, 124 (N.D. Ill. 1980); *Skil Corp. v. Rockwell Int'l Corp.*, 375 F. Supp. 777, 783 n.11 (N.D. Ill. 1974).

Two limitations on applying the Lanham Act to false advertising have been eliminated by the Trademark Law Revision Act of 1988. The prior statute was interpreted by some courts to require that the false statement involve an inherent characteristic of the defendant's goods (*e.g.*, the defendant's claims that their offer was an "exclusive TV offer" and made "for the first time on TV" are not claims concerning inherent characteristic of defendant's jewelry products).<sup>110</sup> The Trademark Law Revision Act eliminates this requirement by explicitly covering misrepresentations about "commercial activities."<sup>111</sup>

Second, a number of courts held that comparative advertising that only disparages a competitor, but does not falsely describe the defendant's product, is not actionable. These courts dissect comparative advertisements to determine whether what was said about the defendant's product is false.<sup>112</sup> Other courts either view the claim as a whole and hold that a false comparative claim is automatically a false claim about the defendant's product or simply enjoin disparaging claims.<sup>113</sup> Fortunately, the Trademark Law Revision Act resolves this inconsistency by making actionable misrepresentations about the defendant's "or another person's goods, services, or commercial activities."<sup>114</sup>

3. *Remedies.*—The principal remedy in Lanham Act cases is an order enjoining the challenged advertising. Often cases are effectively

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110. *Abernathy & Closther, Ltd. v. E & M Advertising, Inc.*, 553 F. Supp. 834, 837 (E.D.N.Y. 1982). *See also Coca-Cola Co. v. Tropicana Prods., Inc.*, 690 F.2d 312, 318 (2d Cir. 1982); *Vidal Sassoon, Inc. v. Bristol-Myers Co.*, 661 F.2d 272, 277 (2d Cir. 1981); *Fur Information & Fashion Council, Inc. v. E. F. Timme & Son, Inc.*, 501 F.2d 1048, 1051-52 (2d Cir.), *cert. denied*, 419 U.S. 1022 (1974). *But see Norwich Pharmacal Co. v. Hoffman LaRoche*, 180 F. Supp. 222 (D.N.J. 1960) (made in laboratories claim held actionable).

111. *See Trademark Law Revision Act of 1988*, Pub. L. No. 100-667, tit. I, § 132, 102 Stat. 3946.

112. *See, e.g.*, *Barr Labs., Inc. v. Abbott Labs.*, 867 F.2d 743 (2d Cir. 1989); *Vibrant Sales, Inc. v. New Body Boutique, Inc.*, 652 F.2d 299, 303 n.3 (2d Cir. 1981), *cert. denied*, 455 U.S. 909 (1982); *SSP Agric. Equip., Inc. v. Orchard-Rite Ltd.*, 592 F.2d 1096, 1103 n.6 (9th Cir. 1979); *Fur Information*, 501 F.2d at 1048; *Bernard Food Ind., Inc. v. Dietene Co.*, 415 F.2d 1279 (7th Cir. 1969), *cert. denied*, 397 U.S. 912 (1970); *Oil Heat Inst. of Or. v. Northwest Nat'l Gas*, 708 F. Supp. 1118 (D. Or. 1988); *Borden, Inc. v. Kraft, Inc.*, 224 U.S.P.Q. (BNA) 811, 818 (N.D. Ill. 1984); *Zerpol Corp. v. DMP Corp.*, 561 F. Supp. 404 (E.D. Pa. 1983); *Ragold, Inc. v. Ferrero U.S.A., Inc.*, 506 F. Supp. 117, 124 (N.D. Ill. 1980).

113. *See, e.g.*, *J S & A Group, Inc. v. Cambridge Int'l, Inc.*, 209 U.S.P.Q. (BNA) 112 (N.D. Ill. 1980) (enjoining claim that Underwriters Labs found all air ionizers other than the defendant's to constitute a shock hazard).

114. *See Trademark Law Revision Act of 1988*, Pub. L. No. 100-667, tit. I, § 132, 102 Stat. 3946.

over after a preliminary injunction is issued. In order to obtain a preliminary injunction, the plaintiff must prove that: (1) the plaintiff will likely win the lawsuit because the advertising is false; (2) the defendant's advertising is likely to cause or have caused injury to the plaintiff; and (3) the plaintiff's injury without the injunction is likely to be greater than the defendant's injury with the injunction (balancing of the hardships).<sup>115</sup> In contrast, when the FTC seeks a preliminary injunction, it need only prove a likelihood of ultimate success on the merits.<sup>116</sup>

Proving the likelihood of injury caused by the advertising in question can be relatively straightforward in injunction cases. It is presumed in cases involving explicit comparative advertisements.<sup>117</sup> Otherwise, injury can be proven by establishing direct competition between the plaintiff's products and the defendant's advertised product.<sup>118</sup>

Although an injunction against advertising that, in most cases, is changed for business reasons may not seem like an effective remedy, it can be disruptive. Under the Lanham Act, a competitor's advertising may be enjoined within "months or even weeks" of its beginning.<sup>119</sup> This compares favorably to some FTC advertising cases that have taken over a decade to resolve.<sup>120</sup> On the other hand, the typical Lanham Act injunction prohibits only specific claims, leaving the advertiser free to make slightly modified claims.<sup>121</sup> Thus, Lanham Act suits may be faster than FTC actions, but are narrower in scope and more easily circumvented by advertising modifications.

Other injunction cases are disruptive because the court orders some sort of affirmative relief. Courts occasionally require the defendant

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115. K. PLEVAN & M. SIROKY, *supra* note 17, at 23-28 (If the challenged conduct has ceased with no reasonable probability that it will be resumed, the court may refuse to issue an injunction.).

116. See, e.g., *FTC v. Pharmtech Research, Inc.*, 576 F. Supp. 294, 299 (D.D.C. 1983).

117. See, e.g., *McNeilab, Inc. v. American Home Prods. Corp.*, 848 F.2d 34, 38 (2d Cir. 1988) (false or misleading comparison to a specific competing product is presumed injurious).

118. See, e.g., *Johnson & Johnson v. Carter-Wallace, Inc.*, 631 F.2d 186, 189-91 (2d Cir. 1980).

119. Keller, *How Do You Spell Relief? Private Regulation of Advertising Under Section 43(a) of the Lanham Act*, 75 TRADEMARK REP. 227, 243-444 (1985).

120. See Pitofsky, *supra* note 25, at 692-93 n.128. Complaints against three marketers of over-the-counter analgesics were issued in 1973, but appeals of the final FTC orders did not occur until 1982 for one and 1984 for the other two. See *Sterling Drug Co. v. FTC*, 741 F.2d 1146, 1148 n.1 (9th Cir. 1984).

121. See, e.g., *McNeilab, Inc.*, 848 F.2d at 36 (within days of the first injunction, defendant launched a revised campaign).

to run corrective notices or to recall its previous advertising.<sup>122</sup> In extreme cases, the courts have banned or recalled the product themselves.<sup>123</sup>

Proving injury in cases in which damages are sought is more difficult. Most courts require proof of lost sales actually caused by the defendant's advertising.<sup>124</sup> This requirement has been a virtual bar to damage recovery for lost sales.<sup>125</sup> Moreover, presenting such proof may expose the plaintiff to broad discovery of its sales figures and planning documents.<sup>126</sup>

### III. DIFFERENCES BETWEEN FTC AND LANHAM ACT CASES

Two recent studies by this author examined 138 FTC advertising cases, including settlements, from July 1978 through June 1988 and 126 Lanham Act false advertising cases with reported decisions through mid-1989.<sup>127</sup> A comparison of the cases examined in these studies provides

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122. For corrective notices, see *Avis Rent A Car Sys. v. Hertz Corp.*, 223 U.S.P.Q. 1255, 1256 (E.D.N.Y. 1984), *rev'd on other grounds*, 782 F.2d 381 (2d Cir. 1986); *John Wright, Inc. v. Casper Corp.*, 419 F. Supp. 292, 333 (E.D. Pa. 1976), *aff'd in pertinent part sub. nom. Donsco, Inc. v. Casper Corp.*, 587 F.2d 602 (3d Cir. 1978); *Ames Publishing Co. v. Walker-Davis Publications, Inc.*, 372 F. Supp. 1, 16 (E.D. Pa. 1974). For advertising recalls, see *Toro Co. v. Textron, Inc.*, 499 F. Supp. 241 (D. Del. 1980); *American Brands, Inc. v. R.J. Reynolds Tobacco Co.*, 413 F. Supp. 1352, 1358 (S.D.N.Y. 1976).

123. *Playskool, Inc. v. Product Dev. Group, Inc.*, 699 F. Supp. 1056 (E.D.N.Y. 1988) (defendant's product could not safely interconnect with plaintiff's product as labeled and advertised); *Haan Craft Corp. v. Craft Masters, Inc.*, 683 F. Supp. 1234 (N.D. Ind. 1988) (injunction of further sale of sewing kits that infringed plaintiff's copyright and were falsely advertised); *Upjohn Co. v. Riahom Corp.*, 641 F. Supp. 1209 (D. Del. 1986) (baldness product claiming to have same ingredient as plaintiff's product recalled); *Ciba-Geigy Corp. v. Thompson Medical Co.*, 672 F. Supp. 679 (S.D.N.Y. 1985) (sale of 15 and 17 hour appetite suppressants enjoined until duration claims established). See also *American Home Prods. Corp. v. Johnson & Johnson*, 672 F. Supp. 135, 143-46 (S.D.N.Y. 1987) (Reye's syndrome warning claim dismissed because FDA now requires warning, but claim to be reinstated if all pre-warning packages are not recalled).

124. See, e.g., *Coca-Cola Co. v. Tropicana Prod. Inc.*, 690 F.2d 312, 316 (2d Cir. 1982); *Johnson & Johnson v. Carter-Wallace, Inc.*, 631 F.2d 186, 191 (2d Cir. 1980); *Donsco, Inc. v. Casper Corp.*, 587 F.2d 602, 607-08 (3d Cir. 1978).

125. See, e.g., *Can-Am Eng'g Co. v. Henderson Glass, Inc.* 814 F.2d 253, 257-58 (6th Cir. 1987) (lower price rather than advertising misappropriation may have caused diminished sales); *Burndy Corp. v. Teledyne Indus., Inc.*, 748 F.2d 767, 771 (2d Cir. 1984); *Donsco, Inc. v. Casper Corp.*, 587 F.2d 602, 607 (3d Cir. 1978) (award of \$462,500 in reasonable damages reversed because lost sales caused by low priced competition and plaintiff's slow deliveries); *Tambrands, Inc. v. Warner-Lambert Co.*, 673 F. Supp. 1190, 1197-98 (S.D.N.Y. 1987); *American Home Prods. Corp. v. Johnson & Johnson*, 654 F. Supp. 568, 592 (S.D.N.Y. 1987) ("It appears virtually impossible to prove, with any degree of reliability, the resulting damages each has sustained through lost sales, profits, and goodwill.").

126. Keller, *supra* note 119, at 244.

127. See Petty, *FTC Advertising Regulation: Survivor or Casualty of the Regan*

insight into the similarities and differences between these two types of advertising cases.

First, it is important to note that these two databases are not perfectly comparable. The FTC study includes cases that are settled, but the Lanham Act study includes only cases with reported decisions. Many of the Lanham Act cases appear to be settled after a reported preliminary decision, such as the denial of a motion to dismiss or the granting of a preliminary injunction; however, many more may have settled without a reported decision.

The best comparison may be between FTC cases that were at least partially litigated and Lanham Act cases with reported decisions. This will still underreport Lanham Act cases because many may have decisions that were not reported.<sup>128</sup> Table One presents the number of at least partially litigated cases with decisions in calendar years 1979-1987. During that time period, the FTC brought over five cases per year. Lanham Act plaintiffs brought almost nine reported cases annually.

**TABLE ONE**  
**Litigated cases by year**

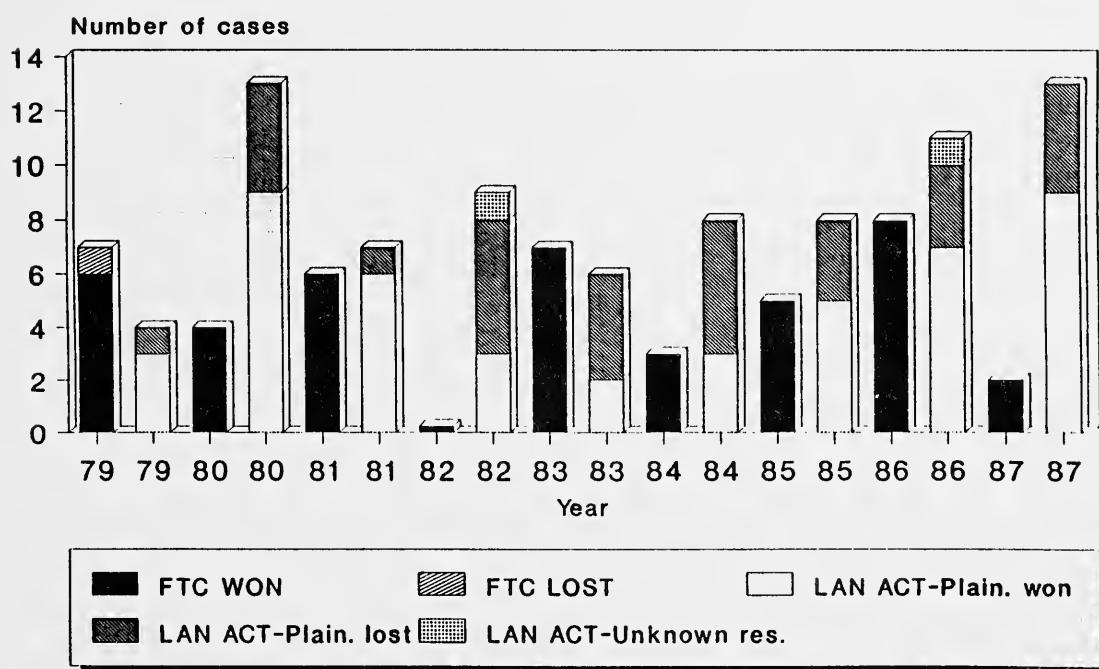


Table One also illustrates the general decline in FTC cases and the increase in Lanham Act cases. The decline in the number of FTC cases

Revolution? (to be published in Vol. 29, American Business Law Journal) [hereinafter Petty, *FTC Advertising*]; Petty, False Advertising Under the Lanham Act: Pro-Consumer Rule or Anti-Competitive Tool? (to be published in Vol. 20, University of Baltimore Law Review).

128. See *Unpublished but Influential*, A.B.A. J., 26 Jan. 1991, at 26.

is not surprising given the cut in resources for advertising enforcement cited earlier.<sup>129</sup> Some of the decrease may be a result of the Commission's new interest in pursuing hard core fraud.<sup>130</sup>

Although the Lanham Act accounts for more cases, the FTC tallies a greater proportion of victories. Nearly sixty percent of FTC advertising cases are settled during the investigation stage before a formal complaint is issued. Moreover, of the fifty-six cases that went into litigation, nearly twenty-four settled before the litigation was concluded. Thus, the FTC wins nearly eighty percent of its advertising cases by settling them.

The Commission's success rate is nearly perfect for advertising cases. It has lost only one of the twelve cases appealed to circuit courts. In that case, *FTC v. Evans Products Co.*,<sup>131</sup> the Ninth Circuit affirmed the district court denial of a preliminary injunction because the practices were not ongoing and because the FTC failed to establish that the claims were misleading.<sup>132</sup> Despite the denial of preliminary relief, the case was favorably settled, with the FTC obtaining for a consumer a redress fund of \$1.9 million.<sup>133</sup>

The only other advertising case loss suffered by the Commission during this time period was the dismissal of the complaint by the administrative law judge (ALJ) in *California Milk Producers Advisory Board of California*.<sup>134</sup> The Commission staff did not appeal this dismissal to the Commission, apparently agreeing with the ALJ that the claim "everyone needs milk" does not violate the Federal Trade Commission Act because less than one percent of the population is allergic to milk.<sup>135</sup>

Thus, the Commission's success rate in advertising cases is reminiscent of Justice Stewart's celebrated dissenting opinion in *United States v. Von's Grocery*<sup>136</sup> that "[t]he sole consistency that I can find is that in litigation under section 7 [the Clayton Act section governing anticompetitive mergers], the Government always wins."<sup>137</sup> The Commission's

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129. See ABA Report, *supra* note 1.

130. Much of the new antifraud efforts involve telemarketing and are outside the scope of this Article. To the extent that telemarketing is replacing advertising as a method of promotion, at least some of this shift appears warranted. Moreover, according to recent congressional testimony, the Commission has obtained \$23.5 million dollars in redress for consumers in telemarketing cases since 1983. More than 18 major telemarketing scams have been closed with court orders against 124 corporate and individual defendants. More than 6,650 victims have received checks ranging from \$50 to \$15,000. Testimony of William MacLeod before the House Subcommittee on Transportation, Tourism and Hazardous Materials (Dec. 3, 1987).

131. 775 F.2d 1084 (9th Cir. 1985).

132. *Id.* at 1089.

133. See 5 Trade Reg. Rep. (CCH) ¶ 22,480 (Oct. 22, 1987).

134. 94 F.T.C. 429 (1979).

135. *Id.* at 558.

136. 384 U.S. 270 (1966).

137. *Id.* at 301.

victorious record in advertising cases stands in stark contrast to its record in nonmerger antitrust cases during this period.<sup>138</sup>

Perhaps some of the FTC's success is accounted for by its focus on fraud. Over ninety percent of the cases during 1978-1988 concern claims that were literally false or unsubstantiated. Only twelve cases focused on claims implied in the advertising.<sup>139</sup> Moreover, only one implied case was brought after 1984.<sup>140</sup>

In contrast to the FTC's nearly perfect record of victories, Lanham Act plaintiffs won only about sixty-five percent of their cases. They obtained injunctive relief for some claims in fifty-two of the total 126 cases. Eleven of those involved relief beyond an injunction.<sup>141</sup> In twenty-six cases, the last reported decision denied the defendant's motion to dismiss the case. These cases were likely settled by cessation of the challenged advertising. Therefore, they are included as plaintiff victories for a total of seventy-eight cases.

In twenty-nine cases, the final outcome was either dismissal of the advertising claims in the complaint or judgment for the defendant on those claims. Another fourteen cases denied the plaintiff injunctive relief. Because there are no later reported decisions for these fourteen cases, the defendant is considered the winner for a total of fifty-three defendant victories. The remaining four cases contain only reported decisions dealing with issues other than the advertising claims, such as motions for change of venue.

Lanham Act cases also were more likely to be appealed and reversed than FTC cases. Of the fifty-six litigated FTC cases, only twelve (or twenty-one percent) were appealed and only one was reversed. Forty-five of the 126 Lanham Act cases were appealed (thirty-six percent) and nineteen of the appealed cases were reversed (forty-two percent). The

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138. See Hobbs, *Swings of the Pendulum —The FTC's First Seventy-Five Years*, 58 ANTITRUST L.J. 9, 12-14 (1989).

139. NEC Home Elec. Corp., 110 F.T.C. 501 (1988); *In re Thompson Medical Prods., Inc.*, 104 F.T.C. 648 (1984), *aff'd*, 791 F.2d 189 (D.C. Cir. 1986), *cert. denied*, 419 U.S. 1096 (1987); Adria Labs., 103 F.T.C. 512 (1984); Estee Corp., 102 F.T.C. 1804 (1983); Christian Services Int'l Inc., 102 F.T.C. 1338 (1983); National Ass'n of Diving Schools, Inc., 100 F.T.C. 439 (1982); American Motors Corp., 100 F.T.C. 229 (1982); Kroger Co., 98 F.T.C. 639 (1981); Beneficial Corp., 94 F.T.C. 425 (1979); ITT Continental Baking Co., 94 F.T.C. 347 (1979); Ford Motor Co., 93 F.T.C. 873 (1979); Kaufman & Broad, Inc., 93 F.T.C. 235 (1979).

140. NEC Home Elec. Corp., 110 F.T.C. 501 (1988). For an analysis of types of implied claims, see Preston, *The Federal Trade Commission's Identification of Implications as Constituting Deceptive Advertising*, 57 U. CIN. L. REV. 1243 (1989). The Reagan Commission's focus on literally false claims may be a factor in the reduction of the use of extrinsic evidence. See *supra* note 46 and accompanying text.

141. See *supra* notes 122-23 and *infra* notes 160-63 and accompanying text.

appellate courts appear to be more deferential to the FTC in advertising cases than to district courts.

The industries represented in these cases are summarized below:

TABLE TWO

<u>TYPE OF PRODUCT</u>	<u>FTC.</u>	<u>Lanham</u>
Advertising to businesses	-	23%
Household durable	45%	22%
Food & Supplements	10%	10%
Drugs	10%	13%
Household disposable	8%	18%
Service	14%	7%
Business opportunities/Investment	11%	-
Vocational school	5%	-
Other	-	4%
<b>TOTAL</b>	<b>103%*</b>	<b>97%*</b>

\* Totals do not equal 100% due to rounding

Although some industries (*e.g.*, food and drugs) receive roughly comparable scrutiny under both laws, other industries receive disparate treatment. For example, advertising to businesses is readily pursued under the Lanham Act, but the FTC pursues investment and vocational school advertising. Lanham Act plaintiffs prefer disposable goods; the FTC favors more expensive durable goods.

#### A. Consumer Effects

*1. Likelihood of Consumer Injury.*—As noted in Section I above, false advertising should be challenged only if it is likely to mislead consumers and cause significant consumer injury. Therefore, to determine the likely consumer benefits, the cases should be examined to see how readily consumers can evaluate advertising claims for themselves and the amount of resulting injury if the claims are false.<sup>142</sup> For example, deceptive pricing claims likely involve little consumer injury because even if the “sale” price is not really a reduced price, consumers can readily determine that it is the price they will pay before they purchase.<sup>143</sup>

The FTC pursued only five deceptive pricing cases during the relevant time period (four percent). Two cases involved undisclosed charges when

142. The Deception Policy Statement advocates such an approach. See Deception Statement, *supra* note 47, at 181.

143. See Pitofsky, *supra* note 25, at 687-89.

the product was bought by mail or phone, and one involved a grocery store's attempt to perform a broad, arguably misleading, price comparison with its competitors.<sup>144</sup> The remaining two cases are of questionable value.<sup>145</sup>

Comparably, under the Lanham Act, only five pricing cases were brought (four percent). Three of these cases involved price comparisons that consumers could check only by contacting different sellers, but the other two cases were of questionable value and were not successful. A real difference emerges when other types of search attribute claims are examined. As the following table shows, the FTC brought no cases involving non-price search attributes, but seven percent (or eight) of the Lanham Act cases fit this category:

TABLE THREE  
Percent of Cases (FTC/Lanham Act)  
Good By Advertised Attribute Type

Good / Attr.	Search	Experience	Credence	Faith	Total
Disp.	1/6	7/20	19/10	5/18	32/54
Dur.	3/4	26/14	33/5	4/16	66/39
Other <sup>146</sup>	0/1	1/0	0/1	0/5	1/7
Total	4/11	34/34	52/16	9/39	

A number of interesting differences surface in this analysis. First, only about ten percent of the FTC cases involve claims that could be verified before purchase (search attributes) or after purchase (experience attributes) for low-price products that are frequently purchased (disposables). Thus, the FTC appears to allow consumers to protect themselves in such cases.

In contrast, nearly one third of the Lanham Act cases fall into those two categories, suggesting that courts do not take into account the ability of the consumer to verify claims. Nothing in the Lanham Act or its related case law requires such consideration. In contrast, the FTC protects only consumers who act reasonably. Arguably, reasonable behavior includes verifying claims when it is easy to do so.

144. See *FTC v. World Travel Vacations, Inc.*, 5 Trade Reg. Rep. (CCH) ¶ 22,505 (N.D. Ill. 1988); *Kroger Co.*, 98 F.T.C. 639 (1981); *Market Development Corp.*, 95 F.T.C. 100 (1980).

145. *Home Centers, Inc.*, 94 F.T.C. 1362 (1979); *Nelson Bros. Furniture Corp.*, 92 F.T.C. 954 (1978).

146. Two FTC cases and seven Lanham Act cases involved low-priced, infrequently purchased goods. One Lanham Act case involved a high-priced, frequently purchased good.

Lanham Act plaintiffs and the FTC bring the same proportion of cases involving experience claims (thirty-four percent), but the type of goods varies. The FTC brings about three times as many experience claim cases for durable goods than for disposables. Lanham Act plaintiffs bring nearly one and one half times as many disposable goods experience claim cases as durable goods experience claim cases.

In fact, in all categories of advertising claims, the FTC strongly favors durable products (roughly two thirds of its cases), whereas the Lanham Act slightly favors disposable products (fifty-four percent of these cases). Competitors are more inclined to protect consumers from being misled into the trial of a frequently purchased product perhaps because of fear of brand loyalty or consumer inertia. On the other hand, the FTC appears to assume that misled consumers will only use a disposable product once.

Nearly ninety percent of FTC cases involved claims that are not readily verifiable or claims for relatively expensive durable items for which repeat purchases occur only after an extended period of time. In such situations, the market incentives for deterring misleading claims are weak, consumer injury is likely to be significant, and thus, the public interest is strong. In contrast, roughly seventy percent of the Lanham Act cases fall into this category of not-readily-verifiable claims or experience claims for durable products. However, plaintiffs only prevailed (obtained an injunction or survived a motion to dismiss) in two-thirds of these pro-consumer Lanham Act cases. Therefore, consumers have the potential to benefit from slightly less than half of the cases brought under the Lanham Act.<sup>147</sup> Because the FTC "wins" virtually all of its advertising cases, consumers appear well-served by ninety percent of FTC cases in these situations.

Two other points deserve mention. First, over half of the FTC cases involve credence claims, but only sixteen percent of the Lanham Act cases do. In contrast, nearly forty percent of the Lanham Act cases involve faith claims, compared to less than ten percent of the FTC cases. Because both types of claims are not readily verifiable by consumers, what accounts for this difference?

One possible explanation is that the FTC likely considers faith claims (product exclusivity, geographic origin, or newness) to be puffing or not material to consumers.<sup>148</sup> Lanham Act plaintiffs and courts may generally

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147. Actually, consumers may benefit somewhat from a deterrent effect because defeated defendants may wish to avoid the expense of future challenges.

148. The FTC does, however, occasionally challenge such claims. It has challenged claims that a product contains a unique ingredient. *See, e.g., Bristol Myers Co. v. FTC* 738 F.2d 554 (2d Cir. 1984), *cert. denied*, 469 U.S. 1189 (1985); *American Home Prods. v. FTC*, 695 F.2d 681 (3d Cir. 1982). It has also challenged claims that a product was new. *See In re Cliffdale Assocs.*, 103 F.T.C. 110 (1984).

consider these claims to be more important. The courts seldom expressly consider materiality and appear willing to presume it.<sup>149</sup>

Second, some of these advertising cases involve product safety issues. In contrast to product liability cases in which consumers benefit from post-injury compensation, these advertising cases benefit consumers by addressing safety concerns before they cause widespread injury. In the past ten years, the FTC has taken action based on a safety theory in twenty-one cases (or fifteen percent of the total). Ten of these cases involve unsafe products,<sup>150</sup> eight concern defective safety equipment,<sup>151</sup> and three address unsafe behavior that is likely to be imitated.<sup>152</sup>

The most common remedy, with the exception of a cease and desist order, is a required warning (nine cases)<sup>153</sup> or a requirement that the product defect be repaired (four cases).<sup>154</sup> Because physical injury to consumers is not explicitly considered in Lanham Act cases, there have been only two safety cases brought under the Act.<sup>155</sup>

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149. See Preston, *False or Deceptive Advertising Under The Lanham Act: Analysis of Factual Findings and Types of Evidence*, 79 TRADEMARK REP. 508, 551-52 (1989).

150. *FTC v. Brown & Williams Tobacco Corp.*, 580 F. Supp. 981 (D.D.C. 1983), *aff'd in part*, 778 F.2d 35 (D.C. Cir. 1985) (cigarettes); *Sun Indus.*, 110 F.T.C. 511 (1988) (tanning booth); *Silver Group*, 110 F.T.C. 380 (1988) (tanning booth); *American Motors Corp.*, 100 F.T.C. 229 (1982) (off-road vehicle); *Farnum Co.*, 96 F.T.C. 826 (1980) (pesticide); *Universal Bodybuilding, Inc.*, 96 F.T.C. 783 (1980) (weightlifting for children); *Jordan Simmer, Inc.*, 95 F.T.C. 871 (1980) (birth control device); *Kettle Moraine Elec. Corp.*, 95 F.T.C. 398 (1980) (insulation); *Montgomery Ward, Inc.*, 95 F.T.C. 265 (1980) (heater); *Bede Aircraft, Inc.*, 92 F.T.C. 449 (1978) (aircraft).

151. *Puritan-Bennett*, 110 F.T.C. 86 (1987) (fire escape hood); *Reliance Wood, Inc.*, 109 F.T.C. 85 (1987) (fire-treated wood); *Aquanautics, Corp.*, 109 F.T.C. 34 (1987) (marine survival suits); *Figgie Int'l, Inc.*, 107 F.T.C. 313 (1986) (heat detector); *Descent Control Corp.*, 105 F.T.C. 280 (1985) (descent system); *Estee Corp.*, 102 F.T.C. 1804 (1984) (cookies for diabetics); *Energy Devices, Inc.*, 102 F.T.C. 1713 (1983) (fire escape mask); *BayleySuit, Inc.*, 102 F.T.C. 1285 (1983) (marine survival suit).

152. *Mentolatum, Inc.*, 96 F.T.C. 757 (1980) (denture cushions used for prolonged period of time); *In re AMF, Inc.*, 95 F.T.C. 310 (1980) (children's bicycles ridden in unsafe manner); *Mego Int'l Inc.*, 92 F.T.C. 186 (1978) (electric hair dryer used near water).

153. *Sun Industries*, 110 F.T.C. 511 (1988) (tanning booth); *Silver Group*, 110 F.T.C. 380 (1988) (tanning booth); *Puritan-Bennett*, 110 F.T.C. 86 (1987) (fire escape hood); *Figgie Int'l, Inc.*, 107 F.T.C. 313 (1986) (heat detector); *Descent Control Corp.*, 105 F.T.C. 280 (1985) (descent system); *Energy Devices, Inc.*, 102 F.T.C. 1713 (1983) (fire escape mask); *American Motors Corp.*, 100 F.T.C. 229 (1982) (off-road vehicle); *Farnum Co.*, 96 F.T.C. 826 (1980) (pesticide); *Jordan Simmer, Inc.*, 95 F.T.C. 871 (1980) (birth control device).

154. *Aquanautics, Corp.*, 109 F.T.C. 34 (1987) (marine survival suit); *BayleySuit, Inc.*, 102 F.T.C. 1285 (1983) (marine survival suit); *Kettle Moraine Elec. Corp.*, 95 F.T.C. 398 (1980) (insulation); *Montgomery Ward, Inc.*, 95 F.T.C. 265 (1980) (heater).

155. *Playskool, Inc. v. Product Dev. Group, Inc.*, 699 F. Supp. 1056 (E.D.N.Y. 1988); *Littlefuse, Inc. v. Parker-Hannifin Corp.*, 230 U.S.P.Q. (BNA) 654 (N.D. Ill. 1986).

2. *Remedies.*—Empirical studies suggest that consumers also benefit from the deterrent value of FTC remedies. FTC cases, in contrast to those brought under the Lanham Act, have a statistically significant effect on the stock market valuation of the challenged firm.<sup>156</sup>

In recent cases, the deterrent value of FTC orders is further enhanced by efforts to obtain monetary penalties. When necessary, the FTC enforces its cease and desist orders in federal district court by seeking civil penalties.<sup>157</sup> The FTC now has the authority to seek federal court injunctions to obtain refunds or an asset freeze (so that money will be available for refunds if the court believes they are warranted) and has done so in almost twenty percent of the recent advertising cases.<sup>158</sup>

In contrast, only five (or four percent) of the Lanham Act decisions awarded monetary compensation based on one of two theories.<sup>159</sup> Two courts awarded damages for intellectual property infringement, but disallowed additional recovery for false advertising for fear of double recovery. Thus, the infringement damages included damages for false advertising.<sup>160</sup>

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156. A. MATHIOS & M. PLUMMER, *REGULATION OF ADVERTISING: CAPITAL MARKET EFFECTS* 31 (1988) (Bureau of Economics Staff Report to the Federal Trade Commission) (finding an average diminution in value of five percent for firms pursued by the FTC). See also Peltzman, *The Effects of FTC Advertising Regulation*, 24 J.L. & ECON. 403 (1981) (only examined FTC cases).

157. 15 U.S.C. § 45(m) (1988).

158. See *FTC v. World Travel Vacations, Inc.*, 5 Trade Reg. Rep. (CCH) ¶ 22,505 (N.D. Ill. 1988) (asset freeze); *FTC v. American National Cellular, Inc.*, 810 F.2d 1511 (9th Cir. 1986) (asset freeze); *FTC v. Rare Coin Galleries of American, Inc.*, 114 F.R.D. 8 (D. Ma. 1986) (asset freeze); *FTC v. Sheldon Friedlich, Inc.*, 5 Trade Reg. Rep. (CCH) ¶ 22,221 (S.D.N.Y. 1985) (asset freeze); *FTC v. Evans Prods. Corp.*, 5 Trade Reg. Rep. (CCH) ¶ 22,480 (1987) (\$1.9 million redress); *FTC v. Kitco of Nev., Inc.*, 612 F. Supp. 1282 (D. Minn. 1985) (refunds); *International Corp. Serv. One*, 106 F.T.C. 528 (1985) (refunds); *Weider Health & Fitness, Inc.*, 106 F.T.C. 584 (1985) (refunds); *Champion Home Builders Corp.*, 101 F.T.C. 316 (1983) (refunds); *Horizon Corp.*, 97 F.T.C. 464 (1981) (refunds); *Mid City Chevrolet, Inc.*, 95 F.T.C. 371 (1980) (refunds); *Art Instruction School Corp.*, 93 F.T.C. 32 (1979) (refunds); *National Sys. Corp.*, 93 F.T.C. 58 (1979) (refunds). See also *supra* notes 91-92.

159. Two false advertising cases that were primarily trademark infringement actions have also awarded the plaintiffs attorney's fees: *Otis Clapp & Son, Inc. v. Filmore Vitamin Co.*, 754 F.2d 738 (7th Cir. 1985) (\$20,000); *Clairol, Inc. v. Save-Way Indus., Inc.*, 211 U.S.P.Q. (BNA) 459 (S.D. Fla. 1980). In a more recent decision, the District of Columbia Circuit declared that attorney's fees are only available in exceptional cases involving willful or bad faith conduct. *Alpo Petfoods, Inc. v. Ralston Purina Co.*, 903 F.2d 958 (D.C. Cir. 1990) (both sides were awarded attorneys fees for pursuing, but not defending, their false advertising claims).

160. *Otis Clapp & Son, Inc. v. Filmore Vitamin Co.*, 754 F.2d 738, 744 (7th Cir. 1985) (\$13,250 profits for trademark infringement disgorged); *Universal Athletic Sales Co. v. American Gym Corp.*, 397 F. Supp. 1063 (W.D. Pa. 1975), *aff'd*, 546 F.2d 530 (3d Cir. 1976), *cert. denied sub nom.* 430 U.S. 984 (1977), *on remand*, 480 F. Supp. 408, 420 (W.D. Pa. 1979) (\$68,650 damages for patent infringement).

Occasionally courts have awarded damages based on the amount of advertising expenditures. Two courts have ordered reimbursement for the plaintiff's "curative" advertising campaign.<sup>161</sup> In a third case, *U-Haul International, Inc. v. Jartran, Inc.*,<sup>162</sup> the district court awarded damages for injury caused by Jartran's false comparison of its trucks with U-Haul's trucks based on U-Haul's curative advertising expenditures added to Jartran's advertising expenditures.<sup>163</sup> The court also justified the award because its amount was comparable to U-Haul's lost profits. The Ninth Circuit affirmed a doubling of the award to \$40 million because of the willful conduct of Jartran.<sup>164</sup>

Recently, the *U-Haul* rationale has been criticized. In *Alpo Petfoods, Inc. v. Ralston Purina Co.*,<sup>165</sup> the district court awarded \$5.2 million in "damages" as the amount of the defendant's false advertising and doubled it for willfulness. The court then noted that the resulting amount of \$10.4 million was close to the plaintiff's share (based on its market share) of the defendant's profits (\$11 million) from the sale of the products falsely advertised. The court of appeals upheld the finding of liability, but reversed the monetary award.<sup>166</sup> The court relied on the traditional standard that the false advertiser's profits and multiple damages can only be awarded for intentional misconduct.<sup>167</sup> Absent such bad faith, the plaintiff must prove its own lost profits caused by the false advertising to recover single damages.<sup>168</sup>

The FTC also benefits consumers more than Lanham Act cases by frequently ordering disclosure of information that might be useful to consumers. Thirty cases ordered the disclosure of specified information, and an additional nine cases ordered disclosures triggered by specified advertising claims. Two courts ordered respondents to provide public service information not directly tied to their product or its advertising. Despite controversy,<sup>169</sup> only three consent orders in the past ten years included corrective advertising, and one of these was later modified to

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161. *Otis Clapp & Son*, 754 F.2d at 745; *Cuisinarts, Inc. v. Robot-Coupe Int'l Corp.*, 509 F. Supp. 1036 (S.D.N.Y. 1981).

162. 601 F. Supp. 1140 (D. Ariz. 1984), *aff'd in part and rev'd in part*, 793 F.2d 1034 (9th Cir. 1986).

163. *Id.* at 1146.

164. *U-Haul Int'l, Inc. v. Jartran, Inc.*, 793 F.2d 1034, 1041-42 (9th Cir. 1986). The award for the costs of Jartran's advertising appears to be based on a disgorgement of profits theory.

165. 913 F.2d 958 (D.C. Cir. 1990).

166. *Id.* at 963-71.

167. *Id.* at 968.

168. *Id.* at 969-70.

169. See, e.g., Pitofsky, *supra* note 25, at 694-701.

remove the requirement.<sup>170</sup> Thus, in thirty-five percent of these cases, the Commission did not merely stop misleading information, but provided additional information to consumers. In contrast, Lanham Act cases seldom order information disclosure relief.<sup>171</sup> One reason for this difference may be the fact that only affirmative misrepresentations are challengeable under the Lanham Act, not omissions.<sup>172</sup> Omissions are often corrected by affirmative disclosures.

### B. Competitive Consequences

In one sense, the FTC's case-by-case approach to advertising is inherently anticompetitive because firms under a broad order are disadvantaged vis-a-vis their competitors who are not under the order. This is true even if the unchallenged competitors are not violating the law. Although this may be somewhat troubling, it is the price paid for any regulatory scheme with prospective relief. This problem may be more troubling if the FTC pursues one firm (subjecting it to civil penalties for future advertising law violations) but not others in the same industry using the challenged practice.<sup>173</sup> If competition in the industry is robust, consumers are not harmed by the restriction of some competitors. On the other hand, if there are only a few firms in the industry, the potential for firms not under FTC order to extract monopoly rents from consumers is greater.<sup>174</sup> Although this problem may appear important, there is no empirical evidence that any FTC advertising orders actually caused this result.

Competitive questions also may be raised by the FTC's pursuit of small firms that appear to be engaged in hard core fraud. These firms may also be characterized as new entrants or marginal competitors. It seems disingenuous to attempt to gain the benefits of rigorous competition for consumers by misleading them into purchasing products that they otherwise would not have purchased. Therefore, there is little reason to believe that the FTC unduly restricts competition through its advertising regulation. In fact, through its antitrust program, the FTC actually encourages competition through advertising.<sup>175</sup>

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170. Commodore Bus. Mach. Inc., 105 F.T.C. 230 (1985); *In re Heatcool, Inc.*, 101 F.T.C. 24 (1983); *In re AHC Pharmacal Co.*, 95 F.T.C. 528 (1980), modified, 101 F.T.C. 40 (1983).

171. See *supra* note 122 and accompanying text.

172. See *supra* note 109 and accompanying text.

173. See Schechter, *Letting the Right Hand Know What The Left Hand's Doing: The Clash of the FTC's False Advertising and Antitrust Policies*, 64 B.U.L. REV. 265 (1984).

174. *Id.* at 266-67.

175. For FTC action against advertising restrictions, see Trade Regulation Rule on

Because Lanham Act cases typically impose specific orders only prohibiting claims proven false, there is less concern that these orders will unduly restrict future competition. However, as noted in Section I, larger firms may have greater incentive to become Lanham Act plaintiffs than smaller firms. Large firms also have an incentive to use the Lanham Act to harass smaller firms to reduce the rigor of competition.<sup>176</sup> Although most Lanham Act advertising cases do not reveal the relative size of the parties, thirty-two (or twenty-five percent) of the decisions indicate that a new entrant or smaller rival was sued. However, like the FTC pursuit of hard core fraud, these cases are disproportionately successful. In twenty-four cases (or seventy-five percent), the plaintiff obtained an injunction and in another four (totaling eighty-eight percent), survived dismissal. Indeed, some of these suits clearly involve small, "outlaw" firms that are engaging in fraud or the infringement of patents or trademarks. The others appear to have little potential for significant consumer injury; therefore, most of these suits should be considered anticompetitive.

The number of suits against new entrants, small firms, and price discounters is only part of the story of the competitive effects of the Lanham Act. Five cases were brought by plaintiff trade associations (four percent).<sup>177</sup> In situations in which no individual firm has sufficient injury to justify a suit, a trade association can share costs and justify the suit based on injury to all of its members. The trade association thereby reduces "free-riding" by nonparticipating firms on the Lanham Act suit of an individual firm. It also allows plaintiff firms to lower their individual costs, while imposing significant costs on a single competitor. Such collective action may arguably constitute conspiracy to monopolize under section two of the Sherman Act.<sup>178</sup>

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Advertising of Ophthalmic Goods & Services, 16 C.F.R. § 456 (1989); Wyoming State Bd. of Chiropractic Examiners, 110 F.T.C. 145 (1988); Tarrant County Medical Soc'y, 110 F.T.C. 119 (1987); Independent Ins. Agent Ass'n of Mont., 108 F.T.C. 99 (1986); Independent Ins. Agents of Am., 108 F.T.C. 87 (1986); Rhode Island Bd. of Accountancy, 107 F.T.C. 293 (1986); American Dental Ass'n, 94 F.T.C. 403 (1979); American Medical Ass'n, 94 FTC 701 (1979), *aff'd*, *FTC v. American Medical Ass'n*, 638 F.2d 443 (2d Cir. 1980), *aff'd*, 445 U.S. 676 (1982). For a discussion of FTC encouragement of advertising, see Petty, *FTC Advertising*, *supra* note 127.

176. See *supra* notes 31-37 and accompanying text.

177. *Camel Hair & Cashmere Inst. v. Association of Dry Goods Corp.*, 799 F.2d 6 (1st Cir. 1986); *Oil Heat Inst. of Or. v. Northwest Natural Gas*, 708 F. Supp. 1118 (D. Or. 1988); *Fur Information & Fashion Council v. E. F. Timme & Sons, Inc.*, 364 F. Supp. 16 (S.D.N.Y. 1973); *Potato Chip Inst. v. General Mills, Inc.*, 333 F. Supp. 173 (D. Neb. 1971).

178. See, e.g., Crew, *Continuing Viability of Pursuing "Traditional" Cases and New Litigation Theories*, 58 ANTITRUST L. J. 289, 295-96 (1989).

Fourteen Lanham Act cases involved associative comparative claims (eleven percent).<sup>179</sup> Such claims do not assert superiority, only comparability. They are much more likely to be used by new or relatively unknown products for which superiority claims would be less credible to consumers. Scammon suggests that associative claims "free ride" on the target firm's reputation investment, but so do superiority claims.<sup>180</sup> The important issue for both types of claims is whether or not they mislead consumers. Associative claims may tend to identify situations in which a dominant firm is suing a small rival.

These potentially anticompetitive uses of the Lanham Act are occasionally tempered by understanding judges and by countervailing pro-competitive uses. In *Mennen Co. v. Gillette Co.*,<sup>181</sup> the court found the suit to be a "competitive ploy," and awarded attorneys fees and costs to the defendant.<sup>182</sup> Although this is the only case to make such an award to the plaintiff, other cases have recognized the potential for abuse. In *Gold Seal Co. v. SC Johnson & Son, Inc.*,<sup>183</sup> the first Lanham Act false advertising case, the court questioned why the advertising had gone unchallenged for seven years, and in denying an injunction and damages, stated that the Lanham Act should not be used to provide a "windfall to an overly eager competitor."<sup>184</sup> Similarly, in *Combe, Inc. v. Scholl, Inc.*,<sup>185</sup> the court denied a preliminary injunction, finding that the claims were not likely to be proven false, and that an injunction at that time would severely injure the defendant's business.<sup>186</sup> Lastly, in

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179. *McNeilab Inc. v. American Home Prods. Corp.*, 848 F.2d 34 (2d Cir. 1988); *Saxony Prods. v. Guerlain*, 594 F.2d 230 (9th Cir. 1979); *Playskool, Inc. v. Prod. Dev. Group, Inc.*, 699 F. Supp. 1056 (E.D.N.Y. 1988); *Tyco v. Lego Corp.*, 5 U.S.P.Q. (BNA) 2d 1023 (D.N.J. 1987), *aff'd*, 853 F.2d 921 (3d Cir. 1988) (per curiam), *cert. denied*, 448 U.S. 955 (1988); *UpJohn Corp. v. Riahom Corp.*, 641 F. Supp. 1209 (D. Del. 1986); *Littlefuse, Inc. v. Parker Hannifin Corp.*, 230 U.S.P.Q. (BNA) 654 (N.D. Ill. 1986); *Cuisinarts, Inc. v. Robo-Coupe Int'l, Inc.*, 580 F. Supp. 634 (S.D.N.Y. 1984); *UpJohn Corp. v. American Home Prods. Corp.*, 598 F. Supp. 550 (S.D.N.Y. 1984); *Sherrel Perfumers, Inc. v. Revlon, Inc.*, 483 F. Supp. 188 (S.D.N.Y. 1980); *Johnson & Johnson, Inc. v. Quality Pure Mfg.*, 484 F. Supp. 975 (D.N.J. 1979); *Electric Corp. of Am. v. Honeywell Inc.*, 303 F. Supp. 1220 (D. Mass. 1969), *aff'd*, 487 F.2d 513 (1st Cir. 1973) (per curiam), *cert. denied*, 415 U.S. 960 (1974); *Smith v. Chanel, Inc.*, 151 U.S.P.Q. (BNA) 685 (N.D. Cal. 1966), *rev'd*, 402 F.2d 562 (9th Cir. 1968); *Societe Comptair de L'Indus. v. Alexanders Dept. Stores*, 190 F. Supp. 594 (S.D.N.Y. 1961).

180. Scammon, *Comparative Advertising: A Reexamination of the Issues*, 12 J. CONS. AFF. 381 (1978).

181. 565 F. Supp. 648 (S.D.N.Y. 1983), *aff'd*, 742 F.2d 1437 (2d Cir. 1984).

182. *Id.* at 657.

183. 129 F. Supp. 928, 940 (D.D.C. 1955), *aff'd*, 230 F.2d 832 (D.C. Cir.), *cert. denied*, 352 U.S. 829 (1956). See also *Johnson & Johnson, Inc. v. Carter-Wallace*, 631 F.2d 186 (2d Cir. 1980).

184. *Gold Seal Co.*, 129 F. Supp. at 940.

185. 453 F. Supp. 961 (S.D.N.Y. 1978).

186. *Id.* at 967.

*Haagen-Dazs, Inc. v. Frusen Gladje, Ltd.*,<sup>187</sup> the court refused to enjoin the defendant's implicit false statement of Scandinavian origin, because the plaintiff had "unclean hands" — it used the same marketing ploy.<sup>188</sup>

In addition to the decisions that demonstrate some sensitivity to competitive concerns, eleven (or nine percent) of these cases have used the Lanham Act as an adjunct to an antitrust claim, presumably to enhance competition.<sup>189</sup> Seven of these occurred before 1979, but none were decided until 1987. The most recent four cases may mark a resurgence in advertising/antitrust cases.<sup>190</sup> In nine cases, small firms challenged the advertising of large firms without alleging antitrust violations.<sup>191</sup> Thus, while there have been some anticompetitive uses of the Lanham Act, other cases have encouraged competition.

## VI. CASE COMPARISONS

The following analysis highlights important differences between FTC cases and Lanham Act competitor lawsuits. Numerous specific comparisons also can be made, but in order to keep this analysis to a manageable size, only four will be discussed. The first two comparisons, concerning

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187. 493 F. Supp. 73 (S.D.N.Y. 1980).

188. *Id.* at 75-76. *But see* Gillette Co. v. Wilkinson Sword Co., Civ. No. 89-3586 (LEXIS, Genfed library, Dist file ) (S.D.N.Y. July 6, 1989) (enjoining implicit claim that a lubricated strip that was six times more slippery would give a better shave, without recognizing plaintiff's implicit claim that its lubricating strip improved shaving).

189. *See* SSP Agric. Equip. v. Orchard Rite, 592 F.2d. 1096 (9th Cir. 1979); *In re Uranium Antitrust Litig.*, 473 F. Supp. 393 (N.D. Ill. 1979); Chromium Ind. v. Mirror Polishing & Plating Co., 448 F. Supp. 544 (N.D. Ill. 1978); Fox Chem. Co. v. Amsoil, Inc., 445 F. Supp. 1355 (D. Minn. 1978); Alberto-Culver Co. v. Gillette Co., 408 F. Supp. 1160 (N.D. Ill. 1976); Smith-Victor Corp. v. Sylvania Elec. Prods. Inc., 242 F. Supp. 302 (N.D. Ill. 1965); Gerber Prods. Co. v. Beechnut Life Savers, Inc., 160 F. Supp. 916 (S.D.N.Y. 1958). The presumption that these Lanham Act antitrust cases are pro-competitive is subject to debate. *See supra* note 33 and accompanying text.

190. Barr Labs., Inc. v. Abbott Labs., 867 F.2d 743 (2d Cir. 1989); National Ass'n Pharmaceutical Mfg. v. Ayerst Labs., 850 F.2d 904 (2d Cir. 1988); Gillette Co. v. Wilkinson Sword, Inc., No. 89-3586 (S.D.N.Y. 1991) (LEXIS, Genfed library, Dist file) (counterclaim for false advertising and monopolization); Bloch v. SmithKline Beckman Corp., No. 82-510 (E.D. Pa. Nov. 1, 1988) (LEXIS, Genfed library, Dist file). For a discussion of advertising/antitrust cases, see Petty, *Predatory Promotion: A Theory of Antitrust Liability Whose Time Has Come?*, 27 AM. BUS. L. J. 215, 217 (1989) [hereinafter Petty, *Promotion*].

191. *See, e.g.*, Avis Rent A Car Sys., Inc. v. Hertz Corp., 782 F.2d 381 (2d Cir. 1986); Alpo Petfoods, Inc. v. Ralston Purina Co., 913 F.2d 958 (D.C. Cir. 1989); United States Healthcare, Inc. v. Blue Cross of Greater Phil., No. 86-6452 (E.D. Pa. 1988) (LEXIS, Genfed library, Dist file); Tambrands, Inc. v. Warner Lambert Co., 673 F. Supp. 1190 (S.D.N.Y. 1987); American Rockwool, Inc. v. Owens-Corning Fiberglass Corp., 640 F. Supp. 1411 (E.D.N.C. 1986) (alleging violation of state tort of destroying business); Borden, Inc. v. Kraft, Inc., 224 U.S.P.Q. (BNA) 811 (N.D. Ill. 1984); Marilyn Miglin Model Make-up, Inc. v. Jovan, Inc., 223 U.S.P.Q. (BNA) 634 (N.D. Ill. 1983); Glenn v. Advertising Publications Inc., 251 F. Supp. 889 (S.D.N.Y. 1966); Marshall v. Proctor & Gamble Co., 170 F. Supp. 828 (D. Md. 1959).

the *U-Haul* cases and comparative advertising, raise the anticompetitive issues in more detail. The second two comparisons, common negative product attributes and the *Kraft* cases, raise specific questions about the Lanham Act's ability to adequately protect consumers.

#### A. *U-Haul Cases*

*U-Haul International, Inc. v. Jartran, Inc.*<sup>192</sup> was the first Lanham Act advertising case to award substantial damages. The damage award and other debts drove Jartran, the only national competitor to U-Haul in the one-way moving equipment rental business, into bankruptcy. U-Haul's actions in the bankruptcy proceeding resulted in an antitrust complaint, issued by the FTC, that was later settled.<sup>193</sup>

In 1979, when Jartran entered the market, U-Haul supplied almost all consumer trailer rentals and sixty percent of consumer truck rentals. Jartran gained almost ten percent of the market in a few months, and U-Haul's revenues were \$49 million lower than it had expected for the post-entry three year period.<sup>194</sup> Jartran's success was attributed, at least in part, to its intentionally false advertising that showed its vehicles to be larger, more attractive, and lower priced than U-Haul's.<sup>195</sup> As has been noted, U-Haul sued under the Lanham Act and was awarded \$40 million.<sup>196</sup>

Jartran subsequently entered bankruptcy, and the FTC accused U-Haul of deliberately using its creditor status to delay the reorganization and continued functioning of its rival. The case was settled by an order requiring U-Haul to notify the FTC, for a ten year period, before it participated in any bankruptcy proceedings of a rival and to provide a copy to the FTC of any lawsuit filed against a competitor.<sup>197</sup>

In *U-Haul*, consumers were protected from deliberately false advertising, albeit on search attributes that they could have verified by visiting a Jartran and U-Haul dealer. The cost of this protection was the loss, for several years at least, of the only national competitor to U-Haul. The main problem appears not to be the injunction against the false claims, but the \$40 million damage award that contributed to Jartran's bankruptcy. The award was based on a doubling of the amount U-Haul spent in counter-advertising which was added to the amount

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192. 601 F. Supp. 1140 (D. Ariz. 1984), *aff'd in part and rev'd in part*, 793 F.2d 1034 (9th Cir. 1986).

193. Amerco, 109 F.T.C. 135 (1987).

194. *U-Haul*, 601 F. Supp. at 1145-48.

195. *Id.*

196. See *supra* notes 162-64 and accompanying text.

197. Amerco, 109 F.T.C. at 135.

Jartran spent on the false advertising.<sup>198</sup> There are several problems with this approach. First, the doubling of the award was inappropriate because of the competitive structure of the market. At most, the court should have awarded single damages as compensation, rather than attempting to further deter wrongdoing in a market with minimal competition.

Second, if compensation is to be given for the expense of counter-advertising, it should be given only for reasonable amounts of counter-advertising not, as in *U-Haul*, when the counter-advertising is more than double the amount of the false advertising.<sup>199</sup> This level of counter-advertising suggests predatory advertising against a new entrant, rather than a desire to merely undo the effects of false advertising.<sup>200</sup>

Third, there is no reason to believe that the sum of the amount of the plaintiff's counter-advertising and the amount of the defendant's false advertising is necessarily equal to the plaintiff's damages or lost profits.<sup>201</sup> U-Haul previously had only advertised in telephone directories, so that its media advertising was a specific response to Jartran's entry and advertising. Lanham Act plaintiffs who use counter-advertising may substitute it for some or all of their regular advertising; therefore, it is difficult to determine what amount is truly an incremental response to the false advertising (or to the entry itself in cases concerning new entrants). Moreover, the amount of the defendant's false advertising cannot be directly related to the plaintiff's injury unless the courts can determine the effectiveness of the advertising. To do so basically requires that the plaintiff prove lost sales caused by the false advertising, the traditional, but usually damages-barring, requirement.<sup>202</sup> It seems that consumers would have been better served by the traditional approach in this case.

### B. Comparative Advertising

Recent estimates suggest that comparative advertising accounts for twenty-five to fifty percent of all advertising.<sup>203</sup> The FTC in the early

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198. *U-Haul Int'l, Inc. v. Jartran Inc.*, 793 F.2d 1034 (9th Cir. 1986).

199. See Best, *Monetary Damages for False Advertising*, 49 U. PITTS. L. REV. 1 (1987); Waltzer, *Monetary Relief for False Advertising Claims Arising Under Section 43(a) of the Lanham Act*, 34 U.C.L.A. L. REV. 953 (1987).

200. See Petty, *Promotion*, *supra* note 190, at 220-23, 244-46.

201. See Heald, *Monetary Damages and Corrective Advertising: An Economic Analysis*, 55 U. CHI. L. REV. 629 (1988).

202. The *U-Haul* trial court attempted to calculate lost sales, but the Ninth Circuit did not consider this theory. *U-Haul Int'l, Inc. v. Jartran, Inc.*, 601 F. Supp. 1140 (D. Ariz. 1984), *aff'd in part and rev'd in part*, 793 F.2d at 1034 (9th Cir. 1986).

203. See, e.g., Freeman, *Comparative Cautions*, MARKETING & MEDIA DEC., Sept. 1987, at 78 (over one third of advertising is comparative today); Levy, *Resurgence in*

1970's began encouraging explicit comparative ads, believing them to be more informative for consumers.<sup>204</sup> Ultimately, the FTC issued a policy statement in 1979 supporting comparative advertising.<sup>205</sup> There is an argument that because comparative advertising appears more informative, it may be more misleading because consumers use it as a substitute for making their own comparisons. Thus, although advertisers should not be able to deceive consumers by falsely advertising their own prices, for example, they may deceive consumers by falsely advertising prices of competitors in comparison to their own. Consumers may believe that because prices are readily verifiable, they need not check. Therefore, they will rely on the false advertisement.<sup>206</sup>

The same reasoning may apply to experience claims for disposable products. For example, in *Vidal Sassoon, Inc. v. Bristol-Myers Co.*,<sup>207</sup> the Second Circuit affirmed an injunction against advertising that implied that 900 women participated in a comparative shampoo test and preferred Body on Tap to Sassoon and other products.<sup>208</sup> In fact, only 200 subjects actually tried both shampoos.<sup>209</sup> Perhaps consumers would rely on this test rather than buy several products to conduct their own head-to-head comparison.

Despite the increase in comparative advertising in the past ten years, the FTC has pursued only one case in which competing brands were named and another twenty-seven cases (or twenty percent of the total) in which unnamed comparisons were made (e.g., safer than aspirin).<sup>210</sup> Thus, the FTC first encouraged competition through comparative advertising and then left it largely unregulated, possibly because of its belief in probable consumer benefits.

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*Comparative Advertisements*, DUN'S BUS. MONTH, Feb. 1987, at 57-58 (half of the advertisements aired by NBC in 1986 were comparative); Swayne & Stevenson, *Comparative Advertising in Horizontal Business Publications*, 16 IND. MARKETING & MGMT. 71, 73 (1989) (in 1985, 23.8% of advertising in these publications was comparative).

204. See Preston & Pridgen, *Enhancing the Flow of Information in the Marketplace: From Caveat Emptor to Virginia Pharmacy and Beyond at the Federal Trade Commission*, 14 GA. L. REV. 635, 673-79 (1980).

205. See In Regard to Comparative Advertising, 16 C.F.R. § 14.15 (1979).

206. See *Thorn v. Reliance Van Co.*, 736 F.2d 929 (3d Cir. 1984) (false price advertising); *U-Haul Int'l, Inc. v. Jartran, Inc.*, 681 F.2d 1159 (9th Cir. 1982) (false price comparisons). See also *Norton Tire Co., Inc. v. Tire Kingdom Co., Inc.*, 858 F.2d 1533 (11th Cir. 1988) (bait and switch price advertising not violative of Lanham Act); Scammon, *supra* note 180, at 384-87.

207. 661 F.2d 272 (2d Cir. 1981).

208. *Id.* at 278.

209. *Id.*

210. The one FTC case challenging an explicit comparison in advertising is *Blue Lustre*, 108 F.T.C. 41 (1986).

In contrast to FTC cases, comparative advertising is challenged under the Lanham Act more frequently than noncomparative advertising. Seventy-one of the 125 cases (or fifty-eight percent) challenged comparative advertisements. This trend has increased in recent years. Since 1980, forty-nine of the seventy-five cases (or sixty-five percent) involved comparative claims. Nearly half of these comparative advertising cases involved explicit differential comparisons and another twenty percent involved explicit associative claims. Thus, in forty-seven Lanham Act cases (or thirty-eight percent), explicit comparative claims were challenged. This figure dwarfs the one explicit comparative advertising case brought by the FTC in the past ten years. Like the FTC caseload, roughly twenty percent of the Lanham Act caseload concerns implicit or vague comparisons.

This difference in the challenge of explicit comparative advertising is not surprising given the fact that large firms that are the predominant targets of explicit comparisons may sue to protect the image of their own brand even when they otherwise would not have sued a rival for false advertising. Because the majority of comparative advertising lawsuits, like all Lanham Act lawsuits, involve disposable products, the question arises whether the legal battles over inducing consumer trial are worth the expenditure of judicial resources.

### C. Common Negative Attributes

Arthur Best argues that competitors will not challenge false claims about each other's products if all the products share the same negative attribute.<sup>211</sup> The example he cites involves competitor challenges under industry self-regulation, rather than the Lanham Act, of inaccuracies in a demonstration of an air cleaner's performance in a smoke-filled chamber.<sup>212</sup> The FTC, on the other hand, challenged whether any of these products work effectively at all.<sup>213</sup> Similarly, Lanham Act cases have challenged taste test claims of cigarettes, but the FTC and Congress have addressed the health consequences of smoking.

Competitors simply lack any incentive to challenge advertising about common flaws, at least until a genuinely improved product is developed. If they were to challenge common flaws, a court may deny relief on the basis of the plaintiff's "unclean hands."<sup>214</sup> Thus, the Lanham Act cannot effectively police all false advertising.

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211. Best, *Controlling False Advertising: A Comparative Study of Public Regulation, Industry Self-Policing, and Private Litigation*, 20 GA. L. REV. 1, 70 n.227 (1985) [hereinafter Best, *Study*].

212. *Id.*

213. *Id.*

214. See, e.g., Haagen-Dazs, Inc. v. Frusen Gladje, Ltd., 493 F. Supp. 73 (S.D.N.Y. 1980).

#### D. *The Kraft Cases*

Perhaps it is surprising that given the hundred plus cases in each set of data, that there was virtually no overlap between FTC and Lanham Act advertising cases. The one exception to this statement are the suits challenging advertising for Kraft Singles cheese.<sup>215</sup> The earlier ads in Kraft's "five ounces of milk" campaign compared the amount of milk used to make Kraft Singles (five ounces) with that used to make imitation cheese products (sometimes indicated as two ounces). The ads also praised Kraft's taste.<sup>216</sup> These early ads were unsuccessfully challenged by Borden, a producer of imitation cheese products.

The court denied an injunction because, under its interpretation of the Lanham Act, Borden had to prove that Kraft made a false statement about Kraft's own product. Although Borden argued that some Kraft singles were made with only four and six tenths ounces of milk, the court found this difference to be immaterial to consumers.<sup>217</sup> The court also dismissed a state law claim of disparagement because Borden could not prove that the statements referred specifically to Borden.<sup>218</sup>

In early 1985, the ads were modified to specifically refer to the benefits of calcium because consumers and other advertisers had a strong interest in calcium.<sup>219</sup> The FTC interpreted these newer ads as implicitly claiming that Kraft Singles had the same amount of calcium as five ounces of milk and had more calcium than imitation slices.<sup>220</sup> The findings of the administrative law judge that these two claims, if made, were false and unsubstantiated, were not appealed. Because of processing, Kraft Singles contain only sixty to seventy percent of the calcium in five ounces of milk. Nondairy cheese products are fortified to a comparable calcium level.<sup>221</sup> The Commission further upheld the ALJ by finding that these claims were material to consumers despite Kraft's materiality survey that purported to show that consumers do not care

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215. *Borden, Inc. v. Kraft, Inc.*, 224 U.S.P.Q. (BNA) 811 (N.D. Ill. 1984); *Kraft, Inc.*, 60 Antitrust & Trade Reg. Rep (BNA) 217 (F.T.C., Jan. 30, 1991). The only other possible exception was not considered on the merits by the court in the Lanham Act case. See *American Consumers, Inc. v. Kroger Co.*, 416 F. Supp. 1210 (E.D. Tenn. 1976) (case dismissed without discussion of the merits because Lanham Act only covers trademark infringement and similar sorts of cases); *Kroger Co.*, 98 F.T.C. 639 (1981) (Kroger found liable for misleading price comparisons).

216. *Borden*, 224 U.S.P.Q. (BNA) at 812-13.

217. *Id.* at 818-19.

218. *Id.* at 821.

219. *Kraft*, 60 Antitrust & Trade Reg. Rep. (BNA) at 219.

220. *Id.* at 221-26.

221. *Id.* at 220.

whether the singles contained 70% or 100% of the calcium in five ounces of milk.<sup>222</sup>

A number of factors account for the different results in these two cases. First and foremost, the advertising copy changed. Although Borden may have been concerned with taste claims, the FTC was not and chose not to challenge the advertisements. Moreover, taste is so subjective that it would be difficult for Borden to prove that Kraft does not taste better because no claims were made about a taste test (the results of which might have been exaggerated).

However, differences in expertise between the Lanham Act plaintiffs, the courts, and the FTC also account for the disparate results. The FTC pursued the implied claims about calcium using tests of consumer perceptions that established that consumers perceived that these claims were made. Borden foolishly pursued the largely truthful express claim about the amount of milk used to produce Kraft Singles. Moreover, Borden attempted to prove disparagement even though its surveys showed that, at best, only five percent of consumers thought that a specific comparison was made to Borden cheese. At a minimum, Borden should have talked to marketing experts such as the one who testified for the FTC and believed that the earlier ads also made implied claims about calcium content.<sup>223</sup>

## V. EVALUATION

This Article has analyzed false advertising regulation by the FTC and by competitors using the Lanham Act. It has examined policy arguments, the legal requirements for proving false advertising, the cases themselves, and several examples of types of cases. It is clear that the Lanham Act has overtaken the FTC as the predominant means of regulating advertising, particularly for comparative claims and disposable products. Thus, regardless of public policy implications, the "privatization" of advertising regulation is occurring. Although a number of commentators have suggested that the FTC Act and Lanham Act are roughly equivalent,<sup>224</sup> or even that the Lanham Act is superior,<sup>225</sup> others omit any discussion of the Lanham Act.<sup>226</sup> This Article suggests that there are significant policy implications in substituting private advertising regulation for public regulation and that these implications should be examined further.

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222. *Id.* at 227-29.

223. *Id.* at 221-26.

224. See Preston, *Deceptiveness*, *supra* note 46, at 1050.

225. See Best, *Study*, *supra*, note 211.

226. See B. BAUDOT, *INTERNATIONAL ADVERTISING HANDBOOK* (1989).

Although many Lanham Act cases appear potentially to protect consumers, others appear potentially anticompetitive, involving large firms "harassing" a smaller firm's advertising to businesses that presumably are sufficiently sophisticated to protect themselves or concerning advertisements that seek to induce consumer trial of disposable products that consumers can inexpensively evaluate for themselves. These uses constitute a questionable use of scarce judicial resources. Judge Goettel noted in 1987 that "[o]ne of the phenomena of the last half of the twentieth century has been the extent to which economic battles have been waged in the courthouse rather than the marketplace."<sup>227</sup> The following year, Judge Kaufman of the Second Circuit opined: "The ongoing competition between . . . rival pain reliever manufacturers has brought anything but relief to the federal courts. Instead, repeated and protracted litigation has created a substantial headache. The competitive battlefield has shifted from the shelves of supermarkets and drugstores to the courtroom."<sup>228</sup>

Moreover, if the benefits of a lawsuit do not accrue to a single competitor, a private advertising case is not likely to be brought. Government regulation is needed to pursue cases that competitors are not interested in and those that are too sophisticated for some plaintiffs or judges. Thus, it appears that competitor lawsuits can partially, but not fully, substitute for government regulation.<sup>229</sup>

The Federal Trade Commission's program of advertising regulation has been criticized in the past as ineffective and anticompetitive.<sup>230</sup> This study shows that the FTC has protected consumers well. The FTC may show little interest in national advertising, but perhaps there is more deception in advertising by smaller firms. An intentionally false advertiser will seek to avoid network review of television ads by placing them locally.<sup>231</sup> Although the FTC's enforcement agenda may not please every-

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227. H.L. Hayden Co. v. Siemens Medical Sys., 672 F. Supp. 724, 727 (S.D.N.Y. 1987), *aff'd on other grounds*, 879 F.2d 1005 (2d Cir. 1989).

228. McNeilab, Inc. v. American Home Prods. Corp., 848 F.2d 34, 35 (2d Cir. 1988). The district court judge was more restrained; he merely noted that "[s]mall nations have fought for their very survival with less resources and resourcefulness than these antagonists." American Home Prods. Corp. v. Johnson & Johnson, Inc., 654 F. Supp. 568 (S.D.N.Y. 1987).

229. See *FTC Anniversary Symposium*, *supra* note 79, at 820-21 (remarks of Mr. MacLeod, then Director of the Bureau of Consumer Protection, that FTC advertising activities are supplanted by industry self-regulation).

230. For early criticisms, see E. COX, R. FELLMUTH, & J. SCHULTZ, *THE NADER REPORT ON THE FEDERAL TRADE COMMISSION* (1969); R. POSNER, *REGULATION OF ADVERTISING BY THE FTC* (1973); Millstein, *The Federal Trade Commission and False Advertising*, 64 COLUM. L. REV. 439 (1964).

231. Cf. *FTC, Texas Charge "Informercials" for Health Care Products Were De-*

one, it does benefit consumers. Second, there appears to be tangible benefits to the FTC's expertise in advertising regulation.<sup>232</sup> The FTC examines potential consumer injury and brings cases that otherwise would not be pursued by competitors such as those in which all competitors share the same product limitations. The FTC also has the discretion to refuse anticompetitive cases or cases with little potential for consumer injury. Lastly, although it lacks the Lanham Act plaintiff's product knowledge, the FTC has the sophistication to pursue cases like *Kraft* more effectively than inexperienced Lanham Act plaintiffs.

If consumer protection is to be accomplished primarily by competitor lawsuits, then four changes should be considered. First, either the Lanham Act or the courts' interpretation of the Act should be modified to require that the plaintiff prove not only the tendency of the ad to mislead consumers, but also the significance of the potential consumer injury from the deception. This change would allow courts to preemptively dismiss cases involving search or experience claims for disposable goods.

Second, the courts should exercise their discretion to limit the anticompetitive effects of competitor lawsuits by imposing costs on plaintiffs for bringing anticompetitive "sham" cases. Courts should also limit remedies imposed on defendants when warranted by the structure and level of competition in the industry to avoid another *U-Haul* situation, where protecting consumers from false advertising may not have been worth subjecting consumers to the whims of a virtual monopolist.

Third, the courts should be willing to entertain consumer plaintiffs under the Lanham Act.<sup>233</sup> Consumer class action suits could pursue cases involving significant consumer injury, but minimal or dispersed competitor injury. Finally, why not privatize more completely by removing the courts from the process? Instead, competitors could challenge each other's advertising under industry self-regulation, as they already do, and not contribute to the backlog of the judicial system.

Many industry trade associations have advertising codes, as do media and media associations.<sup>234</sup> The National Advertising Division (NAD) of the Council of Better Business Bureaus has actively investigated advertising complaints since 1971.<sup>235</sup> It is funded by dues paid to the Council

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ceptive; *Charges Settled Under Consent Agreement Requiring \$1.5 Million in Consumer Redress* (FTC Press Release April 17, 1990) ("informercials" are advertisements that appear to be television programs that are placed on non-network and cable stations).

232. LaRue, *FTC Expertise: A Legend Examined*, 16 ANTITRUST BULL. 1 (1971) (suggesting that the FTC lacks genuine expertise over the courts in antitrust cases particularly those concerning the Robinson-Patman Act).

233. See *supra* note 5 and accompanying text.

234. G. MIRACLE & T. NEVETT, VOLUNTARY REGULATION OF ADVERTISING 29-33 (1987).

235. *Id.* at 83.

of Better Business Bureaus by advertisers and advertising agencies.<sup>236</sup> During 1983-85, forty-three percent of these complaints were made by competitors.<sup>237</sup>

If the NAD cannot resolve the complaint, the case can be appealed to the National Advertising Review Board. The Board is funded in the same manner as NAD, but has decided only forty-one cases that have been appealed to it out of the more than 2,000 investigated by NAD since 1971.<sup>238</sup> In sixty-six percent of the cases, the Board upheld the NAD decision. In twenty percent of the cases, the Board reversed or modified the NAD decision, and fifteen percent of the cases were dismissed or withdrawn.<sup>239</sup> Thus far, advertisers have always complied with a negative Board decision.<sup>240</sup>

NAD standards for reviewing advertising seem comparable to the FTC's standards. For example, in 1984, the NAD took formal action on 105 complaints.<sup>241</sup> Eighty percent of these complaints questioned the adequacy of substantiation and eighty-three percent challenged misleading statements or depictions.<sup>242</sup> In 1984, fifteen of these cases involved explicit comparisons with rival offerings and nearly forty involved implicit comparisons (e.g., "the only lawn fertilizer there is").<sup>243</sup> Lastly, from 1973 through part of 1982, thirty percent of NAD cases dealt with companies in *Advertising Age*'s 100 Leading National Advertisers.<sup>244</sup> Thus, the NAD appears to be more willing than the FTC to deal with national advertisers and comparative advertising.<sup>245</sup>

The cost of complaining to NAD is comparable to complaining to the FTC and is lower than that of bringing a Lanham Act case. Like the Lanham Act courts, NAD acts quickly. It frequently resolves com-

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236. *Id.* at 84.

237. *Id.* at 209.

238. *Id.* at 211, 216, 218.

239. *Id.* at 218.

240. *Id.* at 83-88. If the advertiser does not comply with the Board decision, procedures call for referring the complaint to the FTC. Best, *Study*, *supra* note 211, at 37-38 (noting that two advertisements had not been resolved by the NAD at the close of 1986).

241. G. MIRACLE & T. NEVETT, *supra* note 234, at 216.

242. *Id.* at 226.

243. Best, *Study*, *supra* note 211, at 21-22.

244. Armstrong & Ozanne, *An Evaluation of NAD/NARB Purpose and Performance*, 12 J. ADVERTISING 15, 17 (1983).

245. Until 1972, two major television networks and a number of national print publications banned comparative advertising. The FTC endorsed comparative advertising in a 1971 policy statement and persuaded the television networks to change their policies. See Note, *To Tell The Truth: Comparative Advertising and Lanham Act Section 43(a)*, 36 CATH. U.L. REV. 565, 565-66 (1987). See also *supra* notes 203-10 and accompanying text.

plaints within six months of receipt.<sup>246</sup> NAD examines about one hundred complaints annually.<sup>247</sup> Despite its lack of authority to issue binding orders, it obtains discontinuance or modification in about seventy-five percent of its cases with the remainder vindicating the challenged advertisement.<sup>248</sup> Admittedly, the complete privatization of advertising regulation is neither feasible nor desireable. Although the NAD appears to play its role well, it cannot compel compliance. Furthermore, some will always be suspicious of an industry-sponsored system of regulation. For these reasons, the FTC is needed for at least a small role in advertising regulation. The Lanham Act, on the other hand, can provide faster relief from misleading advertising. These quick injunctions appear most often sought by competitors named in explicit comparisons. Although the business injury to the named rival may be significant in such cases, the injury to consumers is questionable. Therefore, little would be lost, from the consumer perspective, in abolishing advertising regulation under the Lanham Act, leaving this task for the NAD and FTC. The "privatization" of advertising regulation may be unstoppable, but it also can be improved to better serve the public and the taxpayers.

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246. Sixty-four percent of all complaints in 1982 were resolved within six months. Best, *Study*, *supra* note 211, at 47.

247. *Id.* at 20.

248. It examined 107 complaints in 1986 and obtained discontinuance or modification in 75% of them. G. MIRACLE & T. NEVETT, *supra* note 234, at 216.



# **Joint Venture Contracts as Strategic Tools**

**STEVEN R. SALBU\***

## **INTRODUCTION**

Joint venture activity has increased rapidly over the past twenty years,<sup>1</sup> and although research in the field is still incipient, the growing literature on joint ventures reflects both the proliferation of such business endeavors and the questions which are raised by them. Scholars have addressed the particular strategic nature of joint ventures,<sup>2</sup> and much of the existing research concentrates on understanding their success or failure. Studies done by McKinsey and Coopers & Lybrand report a seventy percent eventual break-up rate among joint venture partnerships.<sup>3</sup> This suggests either that joint ventures are inherently unstable and subject to failure or that they adapt to changing conditions by changing ownership, as has been suggested by Harrigan.<sup>4</sup>

International joint ventures have become a separate area of research. Papers have been written concerning the impact of international joint ventures on the American economy,<sup>5</sup> joint ventures in less developed countries (LDCs),<sup>6</sup> and technological cooperation across international

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1. In the late 1980s and early 1990s strategic alliances were formed in industries such as television, electronics, aircraft, and automobiles. See Lazzareschi, *IBM to Develop 64-Megabit Chip With Siemens*, L.A. Times, Jan. 25, 1990, at D1, col. 5; Redburn, *Technology Competition: Time to Fight 'Em or Join 'Em?*, L.A. Times, Nov. 26, 1989, at D1, col. 2; Risen, *GM-Chrysler Project Sets Precedents*, L.A. Times, Feb. 7, 1990, at D2, col. 4; Sanger, *Industries in U.S. and Japan Form Alliance on New TV Technology*, N.Y. Times, Nov. 9, 1989, at 1, col. 1; Uchitelle, *A Japanese Strategy for Boeing*, N.Y. Times, Nov. 3, 1989, at D1, col. 3.

2. See D. HALL, *THE INTERNATIONAL JOINT VENTURE* (1984); K. HARRIGAN, *STRATEGIES FOR JOINT VENTURES* (1985).

3. See Levine & Byrne, *Corporate Odd Couples*, Bus. WEEK, July 21, 1986, at 101-05.

4. K. HARRIGAN, *MANAGING FOR JOINT VENTURE SUCCESS* (1986).

5. Reich & Mankin, *Joint Ventures with Japan Give Away Our Future*, 64 HARV. BUS. REV. 78 (1986).

6. See Beamish, *Joint Ventures in LDCs: Partner Selection and Performance*, 27 MGMT. INT'L REV. 23 (1987); Beamish, *The Characteristics of Joint Ventures in Developed and Developing Countries*, 20 COLUM. J. WORLD BUS. 13 (1985).

borders<sup>7</sup>. Studies have examined joint venture stability using economic analysis,<sup>8</sup> and others have applied economic antitrust analysis to joint ventures.<sup>9</sup>

Much of the existing literature concerning both domestic and international joint ventures suggests that the contract used to establish the venture is of strategic importance. Norm Alster discusses five "dealbusters" which cause strategic alliances to fail: (1) uneven levels of commitment; (2) changing strategic objectives; (3) inadequate internal structures; (4) insufficient executive attention; and (5) lack of internal consensus.<sup>10</sup> Each of these strategic problems can be averted during the contracting process, at which time either the disparity can be addressed or the venture proposal can be rejected, saving effort and money. The process and substance of initial venture contracting are important strategic components of a successful collaboration.

In their article on international collaborative agreements, Morris and Hegert suggest that there are four constant attributes of collaborative agreements: (1) shared responsibility; (2) maintenance of individual identities; (3) continual transfer of resources; and (4) indivisibility of project.<sup>11</sup> All four characteristics of collaboration are inherently contractual, referring to mutual trust, ownership, and control. Because the basic components of a joint venture are themselves contractual, the instrument establishing the venture is an important strategic variable worthy of study.

In any collaborative effort, contracting choices are managerial as well as legal, affecting the strategic implementation of the venture. The following analysis examines different contracting approaches and develops propositions regarding their impact on joint venture strategy. The observations support a concept of contracts which goes beyond the status of legal instrument. Because the various approaches to contracting have implications for corporate planning as well as subsequent behavior within a venture, the process should be viewed holistically as a management tool in which lawyers play a vital strategic role.

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7. Roehl & Truitt, *Stormy Marriages are Better: Evidence from U.S., Japanese and French Cooperative Ventures in Commercial Aircraft*, 22 COLUM. J. WORLD BUS. 87 (1987).

8. Kogut, *The Stability of Joint Ventures: Reciprocity and Competitive Rivalry*, 38 J. INDUS. ECON. 183 (1989).

9. Blackman, *Joint Ventures and the Antitrust Laws*, 40 N.Y.U. L. REV. 651 (1965).

10. Alster, *Dealbusters: Why Partnerships Fail*, ELECTRONIC BUS., April 1, 1986, at 70.

11. Morris & Hegert, *Trends in Collaborative Agreements*, 22 COLUM. J. WORLD BUS. 15, 16 (1987).

## I. CONTRACT TYPOLOGY

Because an inevitable trade-off between stability and flexibility exists in formulating strategy,<sup>12</sup> the typology of contracts along this dichotomous dimension is helpful. The ideal types of contracts which Macneil calls classical, neoclassical, and relational<sup>13</sup> can be viewed on a continuum relative to the underlying transactions and the extent to which they are respectively discrete or relational. A discrete contract can probably never exist as purely defined. Rather, it is an ideal type representing a single transaction in which the parties have neither any past nor any future relationship with each other. In its purest sense, a discrete transaction allows for little planning because it is by definition a present exchange. No contractual arrangement can be entirely discrete because a contract presumes a future relationship following the exchange of promises.<sup>14</sup> Thus, although a present, noncontractual transaction comes closest to approaching discreteness, contracts can be spoken of as discrete depending on the relatively low level at which the parties are personally involved, the simplicity of social exchange, and the unlikeliness of future dealings.<sup>15</sup>

The discrete transaction itself yields no future stability, and Macneil notes that in classical, discrete contractual arrangements, planning must be done beyond the transaction's confines.<sup>16</sup> Whereas relational dealings tend to usurp the market mechanism by incorporating price and quantity into a series of long-range contractual arrangements, discrete dealings must be negotiated over and over from one transaction to another.<sup>17</sup>

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12. See, e.g., Quinn, *Managing Strategies Incrementally*, 10 INT'L J. MGMT. SCI. 613 (1982); Tushman, Newman, & Romanelli, *Convergence and Upheaval: Managing the Unsteady Pace of Organizational Evolution*, 29 CAL. MGMT. REV. 29 (1986).

13. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical and Relational Contract Law*, 72 NW. U.L. REV. 854 (1978) [hereinafter Macneil, *Contracts*].

14. See RESTATEMENT (SECOND) OF CONTRACTS § 1 (1978), which defines a contract as "a promise or set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." Under this definition a contract requires at least two necessary steps: promise and performance. A contract so defined cannot encompass an entirely discrete transaction which has no future element. The simplest contractual arrangement containing one promise rather than a series comes closest to the ideal type which Macneil calls "discrete." See Macneil, *Contracts*, *supra* note 13.

15. Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 738 (1974) [hereinafter Macneil, *Futures*].

16. See Macneil, *Contracts*, *supra* note 13.

17. The use of planning to internalize market mechanisms has been frequently observed in respect to vertical integration and diversification strategies. See, e.g., R. CAVES, AMERICAN INDUSTRY: STRUCTURE, CONDUCT, PERFORMANCE (1982); R. RUMELT, STRATEGY, STRUCTURE AND ECONOMIC PERFORMANCE IN LARGE AMERICAN INDUSTRIAL ORGANIZATIONS

While the low level of commitment over time allows incremental decisionmaking from moment to moment, there exists neither the ability to shift risk to another party nor the ability to stabilize price or supply in ways which might support long-range planning.<sup>18</sup> Although planning occurs through classical contracting and relatively discrete transactions, the planning in such situations must be internal planning regarding a series of rapid and relatively unrelated contracts, rather than mutual planning as applied through relational contracts.<sup>19</sup>

#### A. *Classical Contract*

Macneil's classical contract serves two essential functions: the enhancement of discreteness and the enhancement of presentation.<sup>20</sup> Classical contracts enhance discreteness by reducing the importance of the identity of the parties (*i.e.*, normalizing the participating people or firms via the rules and norms which apply to all). The classical contract concerns transactions in the abstract. Individual identities and idiosyncracies are theoretically irrelevant. Procedures normalize the sources of contractual construction through a series of rules which explain which acts and statements take precedent over others.<sup>21</sup> Remedies for breach are relatively

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(1974). Contracting is a mechanism for stabilizing markets through quasi-internalization: short of consolidating forces with suppliers or buyers, a corporation can purchase products or services for the future through contracting, thereby stabilizing market mechanisms to the extent of the agreement.

18. Risk allocation is a fundamental object of contracting. The consensual commitment to supply resources stabilizes the risk to a seller that buyers at a given price will be in short demand; the analogous commitment to purchase resources mitigates the risk of shrinking supply. For a discussion of the risk allocation function of contracts, see *Kinter v. Wolfe*, 102 Ariz. 164, 426 P.2d 798 (1967). The importance of risk allocation in the contracting process is emphasized in the doctrines of impossibility, commercial impracticability, and frustration of purpose. See *Impracticability of Performance and Frustration of Purpose*, RESTATEMENT (SECOND) OF CONTRACTS Chap. 11 (1978); U.C.C. § 2-615 (1990). The contractual function of risk allocation is evinced as well in the "risk of loss" sections of the Uniform Commercial Code. See U.C.C. §§ 2-509, 2-510, 2-613 (1990).

19. There is evidence that the planning process in most firms occurs in an emergent, gradual fashion which is inconsistent with the traditional, classical discrete contracting process. See J. QUINN, STRATEGIES FOR CHANGE: LOGICAL INCREMENTALISM (1980), in which it is suggested that organizations which attempt to use formal planning mechanisms suggestive of the classical contracting mode in fact exercise a "power-behavioral approach" wherein plans and goals develop incrementally. Quinn's descriptive rather than normative account of planning processes suggests that the use of a series of discrete contracts is inconsistent with the prevailing tendency to develop emergent strategies.

20. See Macneil, *Contracts*, *supra* note 13, at 862.

21. See 3 A. CORBIN, CORBIN ON CONTRACTS § 534 (1960 & Supp. 1991); 4 S. WILLISTON, WILLISTON ON CONTRACTS § 602 (3d ed. 1961). The classical approach to contract interpretation resolves ambiguities by applying rules of construction. When the intention

standard and encourage predictability.<sup>22</sup> Relatively clearly marked standards of offer, acceptance, and consideration separate the realms of being within and without a contractual relationship.<sup>23</sup>

The goal of presentation, or the restriction of future effects through definition and stipulation in the present, is achieved as a by-product of the discreteness discussed above.<sup>24</sup> Presentation, like discreteness, creates stability. Precision and predictability aid in the accurate calculation of the present value of future transactions so that the risk-reduction function of classical contracting is highly specified and reliable. This function has some negative implications, however. Because humans tend to be risk averse,<sup>25</sup> they tend toward conservative strategy. Risk aversion has been blamed for portfolio management of corporations as well as a consequent failure to innovate and operate effectively in competitive markets.<sup>26</sup> Classical contracting and its orientation toward stability may provide a disservice in today's volatile markets.

### B. Neoclassical Contract

Neoclassical contract law lies on a continuum between classical and relational contract. If the classical extreme represents a single, isolated transaction, the relational end represents relationships which approach the creation of an organization.<sup>27</sup> The neoclassical approach to contracts is a compromise between the classical and relational extremes seeking to enhance flexibility in long-term contractual relations while maintaining a significant degree of stability and commitment. The neoclassical contract approach to planning for flexibility incorporates the use of standards,

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of the parties is not clearly manifest in the agreement itself, rules of construction attempt to guess the intent by extrapolating from standard or objective intentions under a given set of circumstances. This provides consistency of results from one instance of contractual ambiguity to another, regardless of the parties. The U.C.C. approach attempts to discern the actual intent of the contracting parties by examining their "course of dealing" in the past or "course of performance" after the contract was made. U.C.C. § 1-205 (1990). The U.C.C. approach is more neoclassical in its attempt to tailor construction to the individual parties' needs rather than to standardize construction in the interest of future generic contractual stability.

22. For a discussion of damages, the normal remedy for breach of contract, see C. McCORMICK, *DAMAGES* (1935).

23. *Cessna Fin. Corp. v. Mesilla Valley Flying Serv., Inc.*, 81 N.M. 10, 13, 462 P.2d 144, 147 (1969), *cert. denied*, 397 U.S. 1076 (1970).

24. See Macneil, *Contracts*, *supra* note 13, at 863.

25. Hayes, *Incorporating Risk Aversion into Risk Analysis*, 20 ENG. ECON. 99 (1975).

26. Hill, Hitt, & Hoskisson, *Declining U.S. Competitiveness: Reflections on a Crisis*, 2 ACAD. MGMT. EXECUTIVE 51 (1988).

27. I. MACNEIL, *CASES & MATERIALS ON CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONSHIPS* 70 (1971).

direct third-party determination of performance, one-party control of terms, and "agreements to agree."<sup>28</sup>

"Standards" refer to the use of criteria extrinsic to a contract which are incorporated by reference into the contract.<sup>29</sup> For example, adjustment of contractual wages based on the consumer price index gives flexibility to long-term contracts while maintaining much of the stability inherent in that medium. In fact, standards comprise an indirect third-party determination of performance.<sup>30</sup>

Direct third-party determination of performance<sup>31</sup> can consist of any contractually arranged mechanism for nonjudicial settlement of disputes, but in its most common form it consists simply of arbitration procedures.<sup>32</sup> Third-party determination can be used both to settle disputes under the terms of the contract and to fill in gaps when the contract has failed to anticipate a dispute.<sup>33</sup> Commonly used in joint venture contracting, third-party determination brings security and rationality to areas of the relationship which might best be left open in deference to the need for flexibility.

One-party control of terms<sup>34</sup> allows a party to the contract the flexibility of a purchased option either to continue or to discontinue the

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28. Macneil, *A Primer of Contract Planning*, 48 S. CAL. L. REV. 627, 657-63 (1975).

29. See Macneil, *Contracts*, *supra* note 13, at 866.

30. The utilization of standards in contract terms ties performance criteria to the unforeseen threats and opportunities in the future environment. This departure from the classical goal of presentation provides an opportunity for improved objective setting in the strategic process. Because the external standards applied in neoclassical contracting often fluctuate on the basis of changes in the environment, the contractual terms have a built-in modulator of unforeseen risk. Accounting for future exigencies in this manner serves both to lessen the risk at the time of contracting and to strengthen the likelihood that the contractual relationship will continue to serve the needs of both parties as originally intended. Although the precise goal of presentation is not served thereby, it is served by a proxy of reasonableness: the standard applied will help ensure that unrepresented results come within the original intent of the parties. Inherent in this neoclassical approach is a strong contention that unrepresented but reasonable results are better than represented results which become both unreasonable and undesirable given the unforeseeable development of contingencies. For a discussion of the role of opportunity and threat assessment in this context, see F. AGUILAR, SCANNING THE BUSINESS ENVIRONMENT (1967).

31. See Macneil, *Contracts*, *supra* note 13, at 866.

32. The progress of contract jurisprudence away from the classical mode and toward the neoclassical and relational modes is reflected in the growing acceptance of arbitration and other forms of alternative dispute resolution in both contract and labor contexts. See, e.g., Boys Markets Inc. v. Retail Clerks Local 770, 398 U.S. 235 (1970).

33. See Macneil, *Contracts*, *supra* note 13, at 865. See Aksen, *Legal Considerations in Using Arbitration Clauses to Resolve Future Problems Which May Arise During Long-Term Business Agreements*, 28 Bus. L. 595, 599 (1973).

34. See Macneil, *Contracts*, *supra* note 13, at 868.

deal.<sup>35</sup> One party buys from the other the luxury of both the stability of a solid contractual claim and the flexibility of opting for a "no-deal" release.<sup>36</sup>

Use of particular cost terms is another neoclassical approach to achieving compromise between stability and flexibility.<sup>37</sup> Typically, the contract clause gives the seller cost plus some stable percentage above cost for profit.<sup>38</sup> These "cost-plus" provisions are similar to the standard setting technique in that they ensure a stable margin while normalizing the cost beneath that margin over time by tying it into the flexible standard of fluctuating costs.

Flexibility is built into neoclassical contracts using "agreements to agree,"<sup>39</sup> which are slippery provisions of questionable binding validity because they lack real substance. When contracting parties want to leave particular terms completely open, but wish to evince their good faith commitment to resolve the gap at a later and more appropriate time, they may include a provision agreeing to do so.<sup>40</sup> The concept is of limited legal value because it is difficult to enforce and likely to be invalidated in court.<sup>41</sup> The value of agreements to agree is more behavioral than legal because the manifestation of any commitment is likely to encourage continued dealings and the future determination of specific terms.

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35. *Id.*

36. Under classical contract law, unilateral options to discontinue a deal under certain conditions often invalidated the contract on the theory that the ostensible consideration was illusory because the agreement lacked mutuality of obligation. *G. Loewus & Co. v. Vischia*, 2 N.J. 54, 57, 65 A.2d 604, 606 (1949). The neoclassical approach of the U.C.C. tends to uphold such contracts based on an assertion that a conditional obligation coupled with a good faith obligation comprises real legal detriment. U.C.C. § 2-316 (1990).

37. See Macneil, *Contracts*, *supra* note 13, at 869.

38. The cost-plus approach has traditionally been employed in the government contracting procurement sector. It has also been developed as a mechanism for inferring price when no price term is explicitly stated. *Kuss Machine Tool & Die Co. v. El-Tronics, Inc.*, 393 Pa. 353, 355, 143 A.2d 38, 40-41 (1958); U.C.C. § 2-305 (1990). The cost-plus approach as a method of upholding agreements through inference of price is a neoclassical departure from the classical notion that a price term was necessary to establish minimal contractual specificity.

39. See Macneil, *Contracts*, *supra* note 13, at 870.

40. Under classical contract law, agreements are unenforceable if their content is uncertain or indefinite. *Parks v. Atlanta News Agency, Inc.*, 115 Ga. App. 842, 156 S.E.2d 137 (1967); *Hill v. McGregor Mfg. Corp.*, 23 Mich. App. 342, 178 N.W.2d 553 (1970); RESTATEMENT (SECOND) OF CONTRACTS § 32(1) (1978). Although agreements to agree may be invalid as contracts for omission of price, time, subject matter, and location terms, they serve the strategic function of developing open and flexible relationships within the context of some psychological commitment.

41. "Agreements to agree" are, *inter alia*, vague and imprecise in regard to the setting of contractual terms, and potentially lacking in consideration. See *supra* note 36 (illusory contracts and mutuality of obligation).

Taken together, these flexibility enhancing devices typify the neoclassical approach to contracting. Although flexibility is gained, an increment of presentation is lost as some degree of total predictability at the time of contracting is sacrificed to future contingencies. The neoclassical genre of contracts makes concessions to planning needs by accommodating a more behaviorally realistic long-term relationship than is foreseen in classical contract theory as applied to wholly discrete transactions. In essence, neoclassical contracts are amenable to gap filling, and they recognize the reality of contractual omissions in all but the most isolated, discrete transactions.<sup>42</sup>

Neoclassical doctrine differs from classical doctrine in regard to consequences of dispute settlement in a manner which may be crucial to strategy, particularly joint venture strategy. Under the classical approach, breach of contract immediately terminates further performance expectations between parties.<sup>43</sup> The classical emphasis on legal remedies in general and monetary compensation in particular is impersonal, rendering the transaction a commodity, the breach of which is easily and predictably compensated.<sup>44</sup> The liberal application of a variety of legal remedies under the Uniform Commercial Code tends to support continued relations and the need for flexibility.<sup>45</sup>

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42. Neoclassical legal doctrines which have developed to increase flexibility of the contractual relationship include impossibility of performance and frustration of purpose. Under either of these defenses, clear and unambiguous agreement of terms can be superseded because performance has become impossible or commercially impracticable due to unforeseen circumstances or because an essential, mutually known purpose of performance has been thwarted by unforeseen forces. *See, e.g.*, *Mineral Park Land Co. v. Howard*, 172 Cal. 269, 156 P. 458 (1916). These common-law principles admit the value of undermining a firm agreement for fairness reasons given unforeseen changes of circumstance. The Second Restatement of Contracts generates similar flexibility, potentially at the cost of contractual stability. For example, to avoid an injustice, a court may supply contractual terms omitted from the document which are "reasonable under the circumstances." *RESTATEMENT (SECOND) OF CONTRACTS* § 292(2) (1978).

43. *See, e.g.*, *Jacob & Youngs v. Kent*, 230 N.Y. 239, 129 N.E. 889 (1921). Substantial performance is considered a constructive condition to a second party's duty to perform under common law. This means that a material breach of contract excuses performance of the nonbreaching party. The effect of this classical approach is to terminate expectations, duties, and relations between parties when a breach occurs.

44. The classic remedy for breach of contract favors discreteness rather than continuous relationships and consequently awards damages rather than specific performance. Thus, under ordinary circumstances, the aggrieved party is entitled to the "benefit of the bargain" in the form of monetary compensation as required to make him whole in new, unrelated market transactions calculated at replacing the lost object or service. Only under extraordinary circumstances, typically when goods or services are considered unique and irreplaceable in the marketplace, is the aggrieved party entitled to specific performance of the promised task. *See Farnsworth, Legal Remedies for Breach of Promise*, 70 COLUM. L. REV. 1145 (1970).

45. The neoclassical approach of the U.C.C. broadened the potential application

Neoclassical contracting attempts to empower a party to force relations to continue during conflict. Grievance and arbitration clauses improve the likelihood of dispute resolution and continuing relations between parties. Clauses are regularly employed prohibiting walkout during resolution of a dispute. Although the binding nature of these clauses is questionable, contractual provisions may encourage continued relations by stipulating compelling damages in the event that a party disrupts performance.

These neoclassical modifications of contracting reflect the classical mode's self-confining, often unresponsive approach to real-life situations. The classic goals of discreteness and presentation are unattainable, most significantly because all eventualities cannot possibly be foreseen between contracting parties. A contract cannot be discrete because it exists in an open system of environmental change,<sup>46</sup> and it cannot attain presentation because the parties are neither prescient nor in full control over a wide array of potential future contingencies. Given the inevitability of these limitations, neoclassical law trades a measure of both discreteness and presentation in order to improve the legal environment in which real parties develop continuing relationships and contracts, the needs of which change over time and cannot be considered either discrete or presented. The gain in flexibility is achieved by inhibiting rigidity of both the terms of contracts themselves and the legal construction of these terms by courts.

### C. Relational Contract

As noted earlier, the classical contract was driven by two ideals, discreteness and presentation, which do not exist in the real world, but instead represent the desire for order, stability, and predictability in business relations. Whereas neoclassical contract theory developed as the natural response to the realities of unpredictability, changing circumstances, and environmental instability, relational contract law is a conscious response to the true nature of business relations.<sup>47</sup> Agreements,

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of specific performance, implicitly emphasizing flexibility and legal support of ongoing contractual arrangements. U.C.C. § 2-716 (1990).

46. The open systems approach is well accepted in the discipline of organization theory. Organizations operate within dynamic and often volatile environments which are crucial to the planning process. For a detailed discussion of the necessity to view organizations as open systems, see D. KATZ & R. KAHN, THE SOCIAL PSYCHOLOGY OF ORGANIZATIONS (1978).

47. The management literature reflects a growing recognition that strategies are, and to a large extent must be, emergent and incremental rather than formal and post hoc. For the classic statement of this tendency, see D. BRAYBROOKE & C. LINDBLOM, A STRATEGY OF DECISION: POLICY EVALUATION AS A SOCIAL PROCESS (1963); Lindblom, *The Science of "Muddling Through,"* 19 PUB. ADMIN. REV. 79 (1959).

far from being neatly packaged and discrete, vary widely and approach, at the relational extreme, the creation of new organizational boundaries. Just as contracts exist creating relationships between separate firms over long periods of time, contractual relationships exist both within functionally structured companies and between the business units of multi-divisional companies. Under these circumstances, discreteness and presentation, still desirable contractual characteristics for reliable planning purposes, become extraordinarily difficult to achieve.<sup>48</sup> These two classic contract goals become ultimately less compelling than flexibility and responsiveness to change as the parties become less discrete (and therefore more relational) and as the environment becomes more turbulent and volatile.<sup>49</sup> Although classical contract theory sacrifices flexibility in favor of stability, relational contract law seeks to accommodate relational priorities.

Relational contract concepts are largely incipient ideals rather than a reflection of significant judiciary trends.<sup>50</sup> Relational notions differ from neoclassical concepts in their ultimate reference to the current and shifting relationship between parties, rather than the original agreement. This is in part the creation of scholars seeking to alter the common law of contracts to meet the current strategic needs of modern firms.<sup>51</sup> Although contractual language is not jettisoned in the process of dispute resolution, it is interpreted loosely and with wide discretion to adapt to a holistic view of the altering relationship. Whereas the neoclassical approach to

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48. There is, however, a trade-off between discreteness and presentation benefits of classical contracting and other types of stability achieved by creating a complex system of relations. Relatively relational contracting has been viewed as a cooperative mechanism for coopting potentially threatening organizations, thereby enhancing stability. J. THOMPSON, *ORGANIZATIONS IN ACTION* 35-38 (1967).

49. The relationship between volatility/turbulence and flexibility is intuitively compelling: the more unpredictable the threats and opportunities in the business environment, the greater the demand for flexible rather than stabilized response mechanisms. Strategic tools for uncertain environments are discussed in O'Connor, *Planning Under Uncertainty: Multiple Scenarios and Contingency Planning*, THE CONFERENCE BOARD REPORT No. 741 (1978).

50. Classical contract ideology can be viewed roughly as comprising the common law of contract, whereas neoclassical contract approaches are embodied in some of the more flexible reforms contained in the Uniform Commercial Code. Relational contracting in its ideal form trades rigid enforcement of legal doctrines and commitment under classical contract law for the adjustment of relations which best manifests the original and developing needs of the parties. This conception of contract is an ideal type rather than a description of the bulk of extant legal doctrine. Relational contract is nonetheless of vital importance in terms of both its descriptiveness of actual classically nonlegalistic behavior of contracting parties as well as its normative value in shaping the future of legal contract doctrine.

51. See, e.g., Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CALIF. L. REV. 2005, 2030 (1987) (discussing the need for adjustment in long-term contracts).

contractual disagreement seeks to end the dispute,<sup>52</sup> relational techniques are less concerned with clear, expedient, unambiguous results. Instead, the techniques sacrifice ultimate dispute resolution in favor of continuing the relationship.<sup>53</sup>

The relational approach to contracts recognizes that although contract terms are finite and circumscribed, the disputes which arise between parties usually do not conform to these pre-existing confines. Instead, they change within a natural context of organic change and development.<sup>54</sup> As a result, disputes are often immune to any effective quick fix based solely on the language of the contract document. Negotiation and mediation, considering both the document and the continuously unraveling pattern of relationships between the parties, may be the most effective mode of resolution.

Macneil's conception of relational analysis admits the continued importance of restitution, reliance, and expectation interests in the process of contracting.<sup>55</sup> Whereas neoclassical scrutiny seeks to protect these three objects by referring to language of promise, relational examination views the realistic expectations of the parties as the product of promises and the development of relational behavior patterns.<sup>56</sup> In seeking to fashion restitution to support a party's reasonable expectations and to support justifiable reliance, reference is made to intent as evinced by contract language and subsequent acts, statements, and overall behavior. As relations become closer, the parties approach a blurring of organizational boundaries. As the relationship develops a culture and set of norms, they also become part of the context in which dispute resolution occurs.<sup>57</sup>

## II. THE ROLE OF LAWYERS AND MANAGERS

Relational contracting seeks to mitigate dysfunction in contracting systems at two levels: the judicial approach to interpreting contracts and

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52. Even the neoclassic invention of arbitration seeks to achieve this relatively discrete end.

53. The relatively discrete and inflexible nature of neoclassical dispute resolution is apparent in the characteristics of traditional litigation. Lawsuits circumscribe, in often unrealistic and unnatural ways, the elements of a disputed transaction. There is typically a winner and a loser, based on a finite set of past events contained in an isolated incident. See, e.g., Chayes, *The Role of the Judge in Public Law Litigation*, 89 HARV. L. REV. 1281, 1283-88 (1976).

54. For a discussion of the inherently organic nature of organizations, see von Bertalanffy, *The History and Status of General Systems Theory*, 15 ACAD. MGMT. J. 411 (1972).

55. See Macneil, *Contracts*, *supra* note 13, at 887-95.

56. *Id.*

57. The application of the extracontractual, idiosyncratic expectations of the parties as well as the norms and culture which arise from the developing relationship to contractual construction is somewhat evident in the U.C.C.'s use of "course of dealing" and "course of performance." See *supra* note 20.

developing common law or U.C.C. doctrines and the strategies utilized by particular parties in drafting contracts.<sup>58</sup>

The planning process can be confounded during the contracting stage when people who are traditionally nonstrategists have influence and control. The fact that lawyers control the contracting process may affect strategy as discussed in the following propositions.

*Proposition 1:* Lawyers think differently than strategists. Specifically, lawyers are trained in contracting to avoid conflict, avoid ambiguity, reduce risk, and foster stability and predictability.<sup>59</sup> Strategists focus instead on adaptation of strengths and weaknesses of the firm to the vicissitudes of the environment.<sup>60</sup> They continually survey the world for new threats and opportunities, and on-going monitoring for changes is considered essential.<sup>61</sup> Flexibility is crucial, and a sustained, continued effort at fashioning new, innovative solutions in unforeseen ways is highly valued. In short, lawyers are likely to be inclined to encourage discreteness and presentation in contracts, whereas strategists tend to value, through their training and experience, ad hoc, flexible responses to environmental shifts.

*Proposition 2:* Incremental strategy, to the extent that it is necessitated by volatility and the need to forestall important strategic decisions to the last possible moment,<sup>62</sup> is more compatible with strategic thinking than with legalistic thinking. Proponents of formal strategic planning give significant attention to continual adjustment, monitoring, steering, contingency planning and the like.<sup>63</sup> Lawyers' work can undermine incremental

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58. See Macneil, *Contracts*, *supra* note 13, at 855. Macneil discusses adjustment of long-term economic relations both in terms of "legal response to planning" and preservation of contractual relationships.

59. See H. BERMAN & W. GREINER, THE NATURE AND FUNCTIONS OF LAW 6 (1980). The authors discuss "the proper purposes of law study" as "understanding the legal order as a vital part of the social order." *Id.* The emphasis on "order" is carried throughout the law curriculum and is particularly salient in procedural doctrines such as stare decisis and due process.

60. For a detailed discussion of this particular orientation, see K. OHMAE, THE MIND OF THE STRATEGIST (1982).

61. See P. LORANGE, CORPORATE PLANNING: AN EXECUTIVE VIEWPOINT 120 (1980). Lorange discusses strategic planning systems as a five-stage process during which monitoring for change through effective environmental surveillance is essential, particularly under conditions of volatility. This process of strategic development and evolution does not fit neatly in the classical contracting mode characterized by discreteness and presentation.

62. For a discussion of the disadvantages of formal strategic planning systems, many of which foster presentation by utilizing an annual planning process which is classical in its attempt to solidify strategic commitments in advance in a formal manner, see Hall, *Strategic Planning Models: Are Top Managers Really Finding Them Useful?*, 8 J. Bus. POL. 33 (1972).

63. See P. LORANGE, *supra* note 61, at 196-99.

thinking to the extent that attorneys emphasize early and complete commitment to clearly specified terms, often with precisely delineated remedies that are more concerned with quick and expedient resolution than continuance of strategic alliance.

*Proposition 3:* Strategic input in the contracting process will tend to be more relational, whereas legal input will tend to be more classical. This follows logically from the first two propositions. Strategists are usually concerned with fashioning workable solutions and continuing desirable ventures, particularly in the instance of joint venture contracting which presumes a close relationship between parent parties. In particular, they will want commitments to be flexible in the event that environmental changes suggest strategic alteration. Attorneys are more likely to approach contracting with one eye looking ahead to disputes, resultant lawsuits, and often a terminal resolution containing a clearly defined issue, an ultimate winner and loser, and a reference to an aging contract which may bear little resemblance to the business relations as they have evolved in a rapidly changing environment.<sup>64</sup>

*Proposition 4:* Lawyers usually have significantly greater input in the joint venture contracting process than do strategists. This phenomenon is a function of two factors: the traditional temerity of laypersons in regard to legal issues and the bifurcation of strategy and law/contracts in the minds of business people.<sup>65</sup>

Taken together, these propositions bear several important implications. Although lawyers tend to be less strategic than strategists and are more likely to err in favor of the more rigid classical form, they may also usurp the joint venture contracting phase because contracts are generally viewed as legal safeguards that no one understands or reads.<sup>66</sup> Several potentially damaging consequences result.

First, in the event of dispute and subsequent litigation, any reference to the contract will tend to reveal discrete, classical contract thinking

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64. For a discussion of the socialization of attorneys in the process of professional legal education in the United States, see L. FORER, MONEY AND JUSTICE 208-211 (1984). Forer observes that much of the training which occurs in law school attempts to teach students to think like lawyers. Given that the traditional case method which conserves traditional and classical approaches to law is still the dominant method of American legal education, it is not surprising that lawyers are socialized to value clear resolution over adaptation.

65. Extensive interviews with strategists for joint ventures have supported these assertions. See S. SALBU, STRATEGIC IMPACT OF THE JOINT VENTURE CONTRACTING PROCESS (1990).

66. The law as it has become relational has begun to recognize the fact that persons routinely sign contracts which they have not read. This phenomenon is in part the basis for such legal doctrines as construction of contracts against the drafter, particularly when the contract is detailed boilerplate and there is a disparity of power between parties. See, e.g., Comprehensive Health Ins. Ass'n v. Dye, 531 N.E.2d 505 (Ind. Ct. App. 1988).

which may impair the possibility of compromise and continuance of a potentially beneficial alliance.

Second, even if no dispute arises, the bifurcation of contracting and strategy as separate spheres of operation can deny the parent companies an invaluable opportunity to use the contracting process strategically: for recognition of threats and opportunities, for optimal negotiating between parties, and for the early and clear creation of workable objectives, goals, programs, and budgets.<sup>67</sup> The labor and capital invested in the creation of the joint venture contract are strategically diminished if done solely by attorneys. The type of thinking that is done in the contracting stage will often approximate scenario building techniques,<sup>68</sup> which attempt to foresee a variety of contingencies and provide for each. This is the kind of activity that is a vital part of the planning process, and significant contracting participation by planners can be an invaluable strategic exercise that yields a contract that is both more strategic and relational.

Third, bifurcation of the contracting and planning functions is a manifestation of the kind of classical thinking that views agreements as discrete rather than relational. The tone set for the entire enterprise may be ideologically regressive, reinforcing a culture wherein clear demarcations are expected and irrational boundaries are supported in the quest for the finite and the discrete. Just when a fluid and organic conception of the relationship is in order, artificial bounds are encouraged.

These propositions and their consequences bear implications concerning the training of lawyers and the allocation of tasks. Attorneys should have less absolute input in drafting the joint venture contract, and strategists should work closely with them to maximize the desired ends of flexibility, responsiveness to environmental change, and the encouragement of any desired relational support.

An alternative view suggests that while strategists should bear greater responsibility in the contracting process, the socialization of attorneys is deficient in its failure to educate lawyers who understand the needs of their clients for mediation, compromise, flexibility, and a tolerable level

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67. While the world of legal commentary has given substantial recognition to the idea of alternative dispute resolution, less emphasis has been placed on preventive legal practices. The unification of legal and strategic aspects of the contracting process should result in more realistic and germane documents that lessen the likelihood of any dispute arising.

68. The literature on scenario building provides an excellent normative framework for lawyers engaged in contract development who attempt to tailor the document to the idiosyncrasies of the particular parties. For a discussion of this strategic technique, see W. ROTHSCHILD, *STRATEGIC ALTERNATIVES: SELECTION, DEVELOPMENT AND IMPLEMENTATION* (1979). Scenario techniques have been used extensively by the Royal Dutch Shell Company. These tools are discussed in ROYAL DUTCH SHELL COMPANY, *THE DIRECTIONAL POLICY MATRIX: A NEW AID TO CORPORATE PLANNING* (1975).

of strategically advantageous ambiguity. If lawyers are trained only to ensure the classic goals of stability and discreteness of transactions, then they are in large part unresponsive to the needs of their business clients as they have evolved.

### III. CONTRACT TYPOLOGY AND TRANSACTION COST ANALYSIS

Joint ventures can be viewed as attempts by parent parties to rationalize and internalize markets by redesigning existing organization configurations.<sup>69</sup> From the perspective of transaction cost analysis, contracts establishing joint ventures should be evaluated based on economies relative to other options. What follows is a summary of the basic markets and hierarchies perspective<sup>70</sup> and a discussion of the relationship between transaction cost concepts and Macneil's contract typologies.

Transaction cost theory is a branch of economics that reduces the level of analysis from the more typical market analysis to the single transaction.<sup>71</sup> The earliest work in the area examined the vertical integration decision and determined that integration is indicated when the cost of a flexible employment agreement is less than the cost of negotiating and executing the contracts used in dealing with an intermediate product market.<sup>72</sup> Under this new economic approach, decisions concerning organizational design were attributed to differential transaction costs.<sup>73</sup>

Markets and hierarchies analysis has been broadened beyond its original scope of contract versus vertical integration issues. This analysis is applied to determine the suitability of three main models for the governance of transactions: (1) markets; (2) quasi-markets, including

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69. A desire to make markets more rational often directs organizations to make an integration versus contracting decision in regard to suppliers and buyers. See Klein, Crawford, & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J. LAW & ECON. 297 (1078).

70. See, e.g., O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975) [hereinafter O. WILLIAMSON, MARKETS].

71. See O. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985).

72. Coase, *The Nature of the Firm*, 4 ECONOMICA N.S. 386 (1937).

73. See Williamson, *The Vertical Integration of Production: Market Failures Considerations*, 61 AM. ECON. REV. 112 (1971). Williamson operationalized this theoretical foundation by modeling the vertical integration decision. He applied transaction costs rather than aggregate measures as the decisionmaking unit of analysis and determined differential costs for various modes of contracts and transactions. In the process, he departed significantly from traditional microeconomic theory, which would examine vertical integration in terms of production functions and the theory of the firm. Williamson's model begins not with what he calls "hyperrational" production functions, but with a more fundamental question which precedes it: given assumptions of bounded rationality, what is the least expensive means of organizing transactions?

"obligational market contracting"; and (3) internal organization.<sup>74</sup> Williamson identified critical criteria for the choice of governance model: the degree of uncertainty, the frequency of transactions, and the degree of idiosyncratic transaction.<sup>75</sup>

The markets and hierarchies literature is not limited to viewing economic decisions from a transaction cost perspective. As make-or-buy is determined to be a function of mitigating transaction costs, the broader question of organizational design is also seen as a transaction cost issue.<sup>76</sup> In particular, the joint venture form may be chosen as a means of minimizing transaction costs.<sup>77</sup>

Overlap exists between the markets and hierarchies approach to economics and Macneil's contract typology. Perhaps because Macneil's three categories are somewhat arbitrary denominations along a continuum, Williamson prefers to refer to the contracts as relatively "hard" or "soft."<sup>78</sup> Hard contracting occurs when autonomous parties express obligations with specificity and under more classic adversarial assumptions. Hard contracts are powerful by virtue of the legal and economic sanctions which are incurred in the event of breach. Soft contracts are made between related, less autonomous parties and lack the specificity of classical contracting. Their power is derived not from legal and economic sanctions, but from social controls and cultural pressure. Soft contracting, or relational contracting in the vernacular of Macneil, relies much more

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74. Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J. LAW & ECON. 233, 247-54 (1979) [hereinafter Williamson, *Governance*].

75. *Id.* at 239. The movement from markets to hierarchies is encouraged when the degree of uncertainty is nontrivial and transactions are frequent and idiosyncratic. A significant degree of uncertainty, threatening the availability of either suppliers or end users, is needed to justify the expense of integration. The number of market transactions must also be frequent enough to amortize efficiently the cost of developing the governance structure. The "idiosyncratic transaction" requirement means that the product is relatively specialized for the use of the buyer. When products are custom made and not for general usage, excess production is wasted and cannot be channeled to other buyers in the marketplace. The threat of waste combined with a need to plan carefully and precisely the number of units needed suggest internal organization as a means of achieving stability.

76. The decision to enter into a joint venture would be attributed in this analysis to reduction of transaction costs. Because the transactions are simply an economic designation of the contracting process, joint venture contracting can be evaluated from the standpoint of transaction cost efficiency.

77. See Hennart, *A Transaction Cost Theory of Equity Joint Ventures*, 9 STRATEGIC MGMT. J. 361 (1988).

78. O. WILLIAMSON, MARKETS, *supra* note 70. See Ouchi, *Markets, Bureaucracies, and Clans*, 25 ADMIN. SCI. Q. 129 (1980). The concept of soft contracting is derived from Williamson's concept of the "economics of atmosphere" and Ouchi's discussion of bureaucratic versus clan-type styles of management. Soft contracting is similar to relational contracting in its less formalistic approach to organizational challenges, which is typical of clan-type arrangements.

crucially on a good fit between the contract itself and the culture into which it is introduced.<sup>79</sup>

Transaction cost theory applied to contract choices suggests that the decision between soft and hard contract style should be a function of the relative cost economies associated with each. Applying transaction cost theory to Macneil's contract typology, the following propositions emerge.<sup>80</sup>

**Proposition 5:** The more a joint venture is steeped in overall conditions of uncertainty,<sup>81</sup> the more appropriate relational contracting will be.<sup>82</sup> This proposition is a function of an underlying assumption: when the environment is predictable, transaction costs of classical contracting, accompanied by discrete, clear distinction between the two parent companies, will be minimized. Conversely, when the environment becomes sufficiently unpredictable and uncertain, transaction costs will be minimized by relational contracting and the development of an ongoing, organic relationship.

Areas in which levels of uncertainty might be relevant in joint venturing include: (1) the speed and nature of technological change; (2) the changing requirements of parent companies for the use of the venture to stabilize supply or market distribution; and (3) the evolving nature of competition in the industry in which the venture operates. When technological change is relatively slow and predictable, hard contracting reduces transaction costs by stabilizing the expectations of the parties in a way that will require little alteration or modification over time. One relatively inexpensive contract iteration fixes technological decisions so that other obligations and opportunities can be fixed at an optimal level of efficiency. Essentially, a single, clearly outlined agreement can be used to delineate technological specifications over a long planning horizon.<sup>83</sup>

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79. Macneil, *Futures*, *supra* note 15, at 738-44.

80. These three propositions directly apply the dimensions of transactions identified by Williamson to the case of joint venture contracting. Williamson states that these critical dimensions are uncertainty, transaction specificity, and frequency. See Williamson, *Governance*, *supra* note 74, at 239.

81. See *id.*

82. By their nature, joint ventures are likely to be characterized by uncertainty to a greater degree than organizations of noncollaborative origin. Although most of the literature regarding the unsettling effects of clashes in culture concern mergers, the principles apply analogously to joint venture situations in which the degree of collaboration can be significant. See, e.g., A. BUONO & J. BOWDITCH, THE HUMAN SIDE OF MERGERS AND ACQUISITIONS: MANAGING COLLISIONS BETWEEN PEOPLE, CULTURES AND ORGANIZATIONS (1989); Buono, Bowditch, & Lewis, *When Cultures Collide: The Anatomy of a Merger*, 38 HUM. REL. 477 (1985).

83. Although highly specific, long-term contracts are more viable under stable rather than volatile conditions. Long-run agreements are more likely to involve informal under-

Relational contracting that fails to fix technological decisions firmly and completely from the beginning leaves room for unnecessary revision and renegotiation of what is essentially a stable variable. In a relational contracting process, the natural pattern of behaviors unharnessed by hard contracting will tend toward wasteful reassessment and repetition of the basic transaction between venturing parties under assumptions of technological stability.<sup>84</sup>

Conversely, if the technology is volatile, classical contracting will be inappropriate because the specificity entailed in this process will need continuous revamping at great transaction cost because lawyers and planners constantly draft new formal agreements. When relational contracting is used in volatile technology cases, the behavioral variation of requirements necessitated by rapidly changing assumptions will be less costly than creating a series of rigid contracts.<sup>85</sup>

The scope of the joint venture contract can also be handled using a relatively classical or relational contracting procedure. If the competitive environment is stable, perhaps by virtue of high barriers to entry and technological limitations to the potential threat of substitutes,<sup>86</sup> classical contracting should minimize transaction costs. Specificity will render the usual advantages of stability, although any loss of flexibility will have minimal impact in an environment which is unlikely to change. When an industry is susceptible to both new entrants and substitute products or technologies, flexibility will be of crucial importance. The ability to maneuver quickly, easily, and with little notice, increases the cost of inflexible, rigid contract terms: A more efficient option in this instance is relational contracting, under which a monitored competitive environment

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standings than short-run agreements because an increased span of time reduces foreseeability by its very nature. The study of informal institutions of contracting is thus especially concerned with longer contracts. See Williamson, *Assessing Contract*, 1 J.L. ECON. & ORG. 177 (1985).

84. For a more elaborate discussion of the nature of fixed bargains in contract law, see Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741 (1982).

85. Likewise, hard contracting will be cost efficient in rationalizing supply or distribution markets only if such markets are fairly stable to begin with. Hard commitment to purchase X units from the venture per year for five years is efficient only under the assumption that the quantity will be adequate over the life of the contract. As often as unstable conditions render the committed amount inadequate, another formal contracting transaction will add to the overall transaction costs. If the quantity specified in a hard contract proves appropriate over the life of the contract, then the important objective of rationalizing supply has been obtained at the bargain rate of one detailed contract.

86. The competitive environment of industries has been addressed in great detail by Michael Porter. Volatility is created by competitive forces which are a product of power of buyers, power of suppliers, barriers to entry, threat of substitute products, and jockeying for position within the industry itself. See M. PORTER, *COMPETITIVE STRATEGY: TECHNIQUES FOR ANALYZING INDUSTRIES AND COMPETITORS* (1980).

is unshackled by unnecessary and unduly burdensome degrees of commitment. Relational contracting can create a culture and framework for more natural responses to change. An increment of transaction cost efficiency is gained in both reduced legal fees and increased speed of decisionmaking.<sup>87</sup>

*Proposition 6:* The more idiosyncratic the transactions between the parent companies and the joint venture, the more appropriate relational contracting techniques will be.<sup>88</sup> Idiosyncratic transactions are those that involve a product or service which cannot readily be diverted to the marketplace in the event that the needs of either party change.<sup>89</sup> The crucial consideration regarding costs for idiosyncratic transactions is high risk. Idiosyncratic products or services have no value if they cannot be used by the particular contracting parties. This phenomenon magnifies the expense of overproduction. The resulting "waste leverage" does not recommend classical contracting, particularly when such leverage exists in a volatile marketplace. Early and specific commitment for the sale and purchase of idiosyncratic products or services augments the likelihood of error in calculating an appropriate target quantity. If the venture is to supply each parent with idiosyncratic products in contractually fixed quantities and is non-negotiable, environmental changes that alter supply needs cannot be accommodated. Production is likely to exceed or to fall short of actual need, and in the former instance, the parents' contractual assumption of risk of oversupply will be extremely costly. A soft contracting process which tends to informalize relationships and internalize market mechanisms avoids such an early overcommitment. Quantity orders can be determined on a rolling basis, resulting in greater accuracy of supply-needs predictions. A concomitant reduction of supply error will reduce the number of idiosyncratic units over which leveraged loss occurs.

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87. See P. LORANGE, *supra* note 61, at 196-99. The logic behind this proposition is supported by Lorange's discussion of the environmental predictability and the optimal degree of delegation. When the environment is stable and predictable, delegation is effective, and when the environment is unstable and unpredictable, a lower level of delegation is recommended. Delegation is a nonrelational analogue of hard contracting. Because future developments are predictable, quantifiable, and stable, one initial contractual transaction is cost efficient. Nondelegation is a relational analogue of soft contracting. Rather than use one legalistic and specific contractual delegation, the decisionmaker is advised to retain discretionary control in order to address decisions at the last possible moment. In this situation, the decisionmaker emphasizes a continuing relationship with key actors so that decisions can be made more idiosyncratically and incrementally, and therefore, more responsively to the volatile environment.

88. See Williamson, *Governance*, *supra* note 74, at 247-60.

89. For a discussion of the nature of idiosyncratic services and products and their relationship to transaction cost economics, see Williamson, *Franchise Bidding for Natural Monopolies — in General and with Respect to CATV*, 7 BELL J. ECON. 73 (1976).

In this way, the soft contracting mechanism should be the more efficient choice under conditions of idiosyncratic transaction.

*Proposition 7:* The more frequent the transactions under the joint venture business, the more appropriate relational contracting will be.<sup>90</sup> Classical contracting is premised on insularity of transactions and the absence of significant ongoing relations. As quantity and frequency of transactions increase, the relational nature of the transactions is strengthened. Patterns of behavior replace rigidly defined contractual arrangements as the more cost efficient option, and parent companies learn to coexist under cultural norms. Although the creation of a strong culture undoubtedly incurs expense, there will be a point at which this expense is exceeded by the cost of enforcing individual classical contract provisions. The expense is likely to be an incidental by-product of the frequently occurring transactions and therefore will be subsumed therein and reduced over time.

The adoption of relational contracting and an appropriate culture of clan-type management should be a natural process.<sup>91</sup> As the frequency of transactions approaches infinity, the market relationship between two completely independent parties should approach synthesis. The joint venture, lying somewhere between these two extremes, should evince transaction cost efficiency by using relational contracting as a function of the frequency of transactions.

#### IV. THE IMPACT OF CONTRACTING CHOICES ON JOINT VENTURE STRATEGY

The discussion to this point has focused on different approaches to joint venture contracting, the tendencies of lawyers and strategy makers in employing these approaches, and the effect of these choices in terms of transaction cost theory. The propositions and observations in the preceding sections play a significant role in improving the use of joint venture contracting in the strategic planning process.

Lorange provides a useful framework for this analysis by describing both symptoms of organizational joint venture dysfunction and strategies for approaching a win-win posture.<sup>92</sup> Symptoms of venture dysfunction include: (1) conflict-ridden internal communication; (2) energy spent on stressful interactions; (3) the static state of a relationship which is ill-

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90. See *supra* note 80.

91. Ouchi distinguished between bureaucratic and clan-style management, reflecting from an organizational standpoint differences which legal scholars characterize as classical and relational contract. See Ouchi, *The Transmission of Control Through Organizational Hierarchy*, 21 ACAD. MGMT. J. 248 (1978).

92. Lorange, *Creating Win-Win Strategies for Joint Ventures* (Wharton working paper 88-103, July 1988) [hereinafter Lorange, *Win-Win Strategies*].

equipped for adaptation; and (4) disparity between partners over time.<sup>93</sup> Conflict in communications can result from a failure of the parties to participate in the setting of procedures and ground rules during the contracting stage and leads to wasted energy which weakens, rather than strengthens interactions because the contracting process does not take the natural development of the relationship between the parties seriously. Likewise, poor adaptation potential is a central weakness of contract processes which attempt to fix terms with greater precision than is necessary strategically.<sup>94</sup> The creation of disparity between partners over time is a natural symptom not only of venture dysfunction but of a failure to address the need for the venture to develop over time within a contractual framework which enhances, rather than impedes the process.<sup>95</sup>

Lorange suggests that a win-win posture can be attained through the process of "putting together and managing the joint venture."<sup>96</sup> The vernacular chosen here is crucial. The creation and management of the venture are viewed as connected functions, implying the importance of structuring the venture through the contracting process. Creation and development are not conceptualized as isolated or insular projects, and in a sense, the importance of relational ideology is thus assumed.<sup>97</sup> In particular, the prescription includes: (1) explicit and realistic understanding of competitive realities when the venture is created; (2) assurance of continued productive contribution by both parents, utilizing the dynamic change of roles if necessary; (3) planning and control routines for easier

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93. *Id.* at 2.

94. For a discussion of the importance of relinquishing control in favor of adaptability within the context of corporate volatility, see J. KIMBERLY & R. QUINN, *NEW FUTURES: THE CHALLENGE OF MANAGING CORPORATE TRANSITIONS* 308-09 (1984).

95. Organizational development has become a function of loosely structured decision processes as technological advances and change occur more rapidly in a highly competitive environment. For a discussion of the strategic foundations for change, see Mintzberg, Raisinghani, & Theoret, *The Structure of "Unstructured" Decision Processes*, 21 ADMIN. SCI. Q. 246 (1976); Van de Ven, *Central Problems in the Management of Innovation*, 32 MGMT. SCI. 590 (1986).

96. See Lorange, *Win-Win Strategies*, *supra* note 92, at 3.

97. The dichotomy in the strategy literature which usually presumes that creation and development are separate and unrelated processes, consists of "formulation" versus "implementation." See, e.g., Cohen & Cyert, *Strategy: Formulation, Implementation, and Monitoring*, 46 J. BUS. 349 (1973). The development of a literature of "management control" likewise distinguishes itself implicitly from creation or formulation of the strategy. See, e.g., Vancil, *What Kind of Management Control Do You Need?*, 51 HARV. BUS. REV. 75 (1973). Implicit in the work of those suggesting incremental or emergent rather than formal strategy is an assumption that the dichotomy between formulation and implementation is false or arbitrary. See Quinn, *Managing Strategies Incrementally*, in COMPETITIVE STRATEGIC MANAGEMENT 35-61 (Lamb, ed. 1984). Relational approaches to contracting are consistent with this philosophy.

adaptation; (4) effective human resource management modes which aid rather than impede managerial motivation; and (5) enhancement of learning in the venture process.<sup>98</sup>

These win-win vehicles and the contracting process are related. The contracting process is crucial to the manner in which understandings are evinced and constructed by the parties. Likewise, the creation of a system which supports dynamic change and assures commitment to and continuing benefit from the venture by both parents is the goal of successful relational contracting. At the center of relational techniques is the recognition that dynamic change can be a more important criterion for success than specificity, presentation, and predictability of terms.<sup>99</sup> Planning and control routines for easier adaptation are essentially relational as well. Managerial motivation in complex and rapidly changing environments will be subsumed in the ability of the venture to react flexibly to volatile environmental signals.<sup>100</sup> For these reasons, relational contracting appears to be more compatible with the development of joint ventures than the more traditional classical and neoclassical modes. A number of propositions follow from this observation as well as the preceding propositions.

*Proposition 8.* Understanding of competitive realities at the time the venture is created can be significantly enhanced if venture parents become more involved in the joint venture contracting process. The connection between contracting and the competitive environment is not immediately evident, and in fact, the two may appear to be unrelated. Contracting is traditionally viewed as a manifestation of the agreements between two parties,<sup>101</sup> although the competitive environment is seen as a relatively immutable given which simply provides structure to the framework in which strategy occurs.<sup>102</sup> Only when the tendency to view the contracting and strategic processes in isolation is transcended can we begin to witness the potential usefulness of contracting in understanding competitive realities.<sup>103</sup>

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98. See Lorange, *Win-Win Strategies*, *supra* note 92, at 3-4.

99. Macneil, *Futures*, *supra* note 15, at 738-44.

100. These fundamental win-win components are reflected in Lorange's final emphasis: enhancement of learning in the venture process. Such learning applies to all the other four criteria and would not be important if it did not yield the possibility of strategic shifts, reordering of priorities and processes, and in rethinking every central element of the venture in general. In other words, implicit in this emphasis on learning is the assumption that win-win strategies must certainly contain a mechanism for change and development at a minimum. This mechanism is really the central thrust of relational contracting and the ends it seeks to support.

101. See, e.g., *Russell v. Union Oil Co.*, 7 Cal. App. 3d 110, 86 Cal. Rptr. 424 (1970); *Cessna Fin. Corp. v. Mesilla Valley Flying Services, Inc.*, 81 N.M. 10, 462 P.2d 144 (1969), *cert. denied*, 397 U.S. 1076 (1970).

102. See *supra* note 86.

103. For example, the parents of a joint venture should not enter an agreement

*Proposition 9.* Continued, good faith contribution by both parents can be supported by real parent participation in a relational contracting process. Lorange suggests that different underlying agendas can impede the functioning of the joint venture, often resulting in a lack of openness and honesty.<sup>104</sup> Under these conditions, a discrepancy is likely to develop between a parent company's stated goals and its actions.<sup>105</sup> This type of inconsistency can endanger the continued success of the venture and lead to disagreement, hostility, and additional subterfuge. When the parent companies participate in the contracting process instead of delegating contracting to lawyers, they obtain psychological ownership of the arrangement and are more likely to discover and negotiate differences in underlying agendas before the implementation stage.<sup>106</sup>

Meaningful participation in an ongoing, relational contracting process thus serves to strengthen commitment and understanding between parties, enhancing the likelihood of sound implementation of the venture's programs. To the extent that this function cannot be perfect, relational contracting can provide economic incentives for compliance in the event of conflicting interests. Examples of these incentives include reciprocal

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concerning the legal and strategic scope of the venture without examining the competitive environment. Among other things, competitive analysis will help reveal the difficulty of competing in a particular industry, the likelihood and magnitude of potential profitability in that industry, and the degree of industry infighting which can be anticipated by the level of competition therein. *See supra* note 86. The contracting stage is an ideal time for the strategic collaboration of partners in this regard because contracting must occur for legal reasons independent of strategy and because the partners will be the authors of the contractual results.

104. *See* Lorange, *Win-Win Strategies*, *supra* note 92, at 13.

105. Even when they operate in a forthright manner, organizations are subject to epiphenomenal discrepancy between stated goals and actual results. This occurs because the process of role-sending, crucial to the implementation of goals, can be flawed by role conflict (wherein a number of legitimate expectations of an individual are mutually inconsistent) and role ambiguity (wherein individuals experience uncertainty simply because of cognitive limitations). *See* R. KAHN, E. WOLFE, R. QUINN, J. SNOEK, & R. ROSENTHAL, *ORGANIZATIONAL STRESS STUDIES IN ROLE CONFLICT AND AMBIGUITY* (1964); Lieberman, *The Effects of Changes in Roles on the Attitudes of Role Incumbents*, 9 HUM. REL. 385 (1956). Although implementation of strategy is always potentially confounded by these naturally occurring phenomena, the venture can seek to avoid adding an additional layer of dishonesty by encouraging good faith commitment during the contracting process.

106. Organization theory has long recognized the value of co-optation in the creation of commitment which might not occur naturally. Co-optation occurs when an organization brings another person or organization into the decisionmaking process. This inclusion tends to help ensure commitment to the decisions reached. This is particularly relevant in regard to joint ventures, in which two potentially conflicting organizations seek to cooperate on some level. Organizational boundary spanning can rationalize relationships between parent companies and the contracting process serves this function when it creates real bridges. For discussion of boundary spanning, see Leifer & Delbecq, *Organizational/Environmental Interchange: A Model of Boundary Spanning Activity*, 3 ACAD. MGMT. REV. 40 (1978).

penalties,<sup>107</sup> bundling of commitments,<sup>108</sup> and rewards for altruism.<sup>109</sup>

Incentive schemes, both in and apart from the contract terms, are essentially either neoclassical or relational in their nature. They tie the continued behavior and support of parent companies to a loosely connected web of rewards and penalties which are often triggered by mechanisms other than litigation or grievance. As such, they benefit from being automatically tied to the unpredictable development of the relationship between the parties as they pursue venture goals.

There is, however, a proviso: the quality of behavior is only as effective as the structurally incorporated mechanism for self-regulation of compliance and the commitment of the parties. When the parties are establishing procedures into which behavior-altering terms are built, it is essential that the quality be high and the parents be sold on their validity. Parent companies in reality often divorce themselves from the legal processes in which these procedures can be crafted, leaving a vacuum in which they are copied from the prior boilerplate of other ventures.<sup>110</sup> If the parties abdicate responsibility for the terms of commitment by viewing them as legal, rather than strategic, they lose an opportunity to improve the chances that the joint venture will succeed and operate smoothly. *Proposition 10.* Planning and control routines that facilitate adaptation<sup>111</sup> are essentially relational in nature. Thus, contracts which are loosely

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107. Kogut, *supra* note 8, at 195-97. Reciprocal penalties exact a charge upon the violating party equivalent to its transgression. They help to mitigate opportunistic behavior which arises naturally when competitors enter into a cooperative situation such as a joint venture. The value of reciprocal penalties depends on two factors: the likelihood that a prospective violator will be caught and the magnitude of detriment experienced by a violator in the event that the penalty is charged. If the penalty is only as detrimental as the violation was beneficial, and the violation is unlikely to be discovered, the risk involved in opportunism may be economically justified. Because of this effect, "more than reciprocal" penalties might be more effective.

108. Bundling provisions in a joint venture contract tie various commitments into an interrelated web of contingency. Duties of parent A become triggered by the occurrence of an act by parent B, or parent A is relieved of a duty by virtue of nonperformance of parent B. In either case, the bundling provision is a self-policing method of implementing reward and punishment systems. Bundling serves as a mutual hostage situation which can stabilize the transactions in a relationship. For a discussion of the use of mutual hostages, see Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

109. Rewards for altruism mitigate opportunistic behavior by creating countervailing incentives. In this manner they help balance the scales which naturally favor opportunism.

110. S. SALBU, *supra* note 65, at 38-43.

111. The importance of adaptation is well established in the strategy literature. See, e.g., H. MINTZBERG, MINTZBERG ON MANAGEMENT: INSIDE OUR STRANGE WORLD OF ORGANIZATIONS (1989); Alexander, *Adaptive Change in Corporate Control Practices*, 34 ACAD. MGMT. J. 162 (1991); Zajac & Shortell, *Changing Generic Strategies: Likelihood, Direction and Performance Implications*, 10 STRAT. MGMT. J. 413 (1989).

structured and which allow the relationship between venturing parties to develop in unanticipated ways are most likely to ensure the survival<sup>112</sup> and the effectiveness of the venture.<sup>113</sup>

Lorange suggests a paradox which underlies the success of venture development: the venture must be controlled, but not overcontrolled, so that control exists "along clearly set dimensions, allowing sufficient autonomy."<sup>114</sup> Among the implications here are: (1) that the parents should not smother the venture with attempts to get involved in its management and (2) that notwithstanding this warning, there must be enough control to support rather than inhibit the freedom and autonomy of the venture to surpass presentiated expectations under classical contract modes.<sup>115</sup>

The degree of control within a contract can be classified alternatively as: (1) procedural or substantive; (2) insufficient or excessive; (3) appropriate or inappropriate; or (4) internalized or noninternalized. The propositions which follow suggest that these choices are strategically and legally important.

*Proposition 11.* Procedural control is more likely to be relational in character, whereas substantive fixation of agreements is more likely to be classical.<sup>116</sup> Whereas procedures are content nonspecific and serve simply to clear a pathway for the natural development of the venture, substantive clauses are by definition specific and yield discrete and presentiated obligations. The relative strength of procedures consists of their value in

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112. Success in survival of joint ventures can be a problem because of failure to adapt successfully to unforeseeable contingencies. See Levine & Byrne, *supra* note 3, at 101-05.

113. The relational conception of organizational effectiveness in the strategy literature is usually termed "proactiveness," which is a means of changing the strategy process in an adaptive and anticipatory manner rather than a reactive manner. See B. CHAKRAVARTHY & P. LORANGE, *MANAGING THE STRATEGY PROCESS: A FRAMEWORK FOR A MULTIBUSINESS FIRM* 302 (1991).

114. See Lorange, *Win-Win Strategies*, *supra* note 92, at 22.

115. This balance is poorly served by classical contracting philosophy. The classical mode errs entirely on the side of control in its efforts toward both discreteness and presentiation. The conceptual opposite of control in the organization literature is contained in the relatively novel idea of "empowerment" of both individuals and institutions. The literature regarding empowerment often focuses on the relational concepts of risk-taking and innovation. See, e.g., Thomas & Velthouse, *Cognitive Elements of Empowerment: An "Interpretive" Model of Intrinsic Task Motivation*, 15 ACAD. MGMT. REV. 666 (1990); Walton, *From Control to Commitment in the Workplace*, 63 HARV. BUS. REV. 77 (1985).

116. Procedural control can be defined as "embracing the systems and methods available to enforce the rights specified" substantively. T. MCADAMS, *LAW, BUSINESS AND SOCIETY* 107 (1986). Because such procedures must refer back to some substantive form of control, procedural control cannot exist in a pure and insular form. When we speak of procedural and substantive control, we therefore refer to a general emphasis, force, or impact, rather than the actualization of ideal types.

enhancing flexibility,<sup>117</sup> while the relative strength of substantive clauses reflects the pinning down of specific terms in a way that fixes obligations so that the parties can rely on the risks they willingly assume. In terms of Lorange's delicate balance between functional and dysfunctional control, the procedural-relational types of control are more likely to bring the flexibility associated with free and autonomous management.<sup>118</sup>

*Proposition 12.* Emphasis on relational contracting is likely to create a self-regulating mechanism which negotiates the balance between over-control and under-control.<sup>119</sup> As long as the allocation of overall power and responsibility is addressed and procedures and structures are established for the changes the venture will face, there is little risk of over-control. The intentional omission of many fixed, substantive terms reflects the postponement of commitment<sup>120</sup> which, if made too early, will be a form of excessive control that binds the venture management to conditions established by contracting parents. This is precisely the type of impediment to autonomy which impairs the likelihood of a win-win venture. At the same time, the frameworks and procedures of relational contracting help ensure that the venture will not be undercontrolled. By creating clear lines of authority, mechanisms for dispute resolution, and channels for development, the opportunities to exercise a reasonable degree of control are assured.

*Proposition 13.* Relational contracting is more likely than classical contracting to result in internalization of control mechanisms.<sup>121</sup> Parents of

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117. Examples of flexibility enhancement through the emphasis of procedure over substance are agreements to agree and forums for alternative dispute resolution which are more neoclassical or relational than classical in nature. Emphasis on procedures for change in the absence of clearly specified substantive provisions provides flexibility at the expense of clearly delineated obligations on which both parties can rely.

118. A movement from substantive to procedural emphasis within contracts serves to make the development of the contract more idiosyncratic and less an objective reflection of the biases which have developed under the common law of contract. For a discussion of this bias, see Kennedy, *Distributive and Paternalistic Motives in Contract and Tort Law*, 41 Md. L. Rev. 563 (1982).

119. See Lorange, *Win-Win Strategies*, *supra* note 92, at 15-25. A venture must be controlled enough to create an independent, meaningful managerial life, but not so controlled that it impairs freedom of response to environmental cues. Lorange recognizes the need to clearly identify management teams and responsibilities and clearly delineate authority and limits to responsibility.

120. Timing of commitment has been viewed as an important control issue in both traditional budgeting theory and more current strategic monitoring theory. The essence in each case reflects an advantage in postponing commitments until the last possible moment in order to gain increments of information and thereby improve the quality of decisions, particularly under conditions of uncertainty. See, e.g., J. BOWER, *MANAGING THE RESOURCE ALLOCATION PROCESS: A STUDY OF CORPORATE PLANNING AND INVESTMENT* (1970); W. NEWMAN, *CONSTRUCTIVE CONTROL* (1975); Schiff & Lewin, *Where Traditional Budgeting Fails*, in *BEHAVIORAL ASPECTS OF ACCOUNTING* 132 (M. Schiff & A. Lewin eds. 1974).

121. Control mechanisms become internalized to the extent that they are incorporated

joint ventures often regard the contract creating the venture as a device to consult only upon the reaching of irreconcilable differences.<sup>122</sup> Agreements are seen as irrelevant unless and until there is a problem. Yet variables will often fail to manifest themselves as important concerns if lawyers operate in isolation from parent company representatives. The contract as classically conceptualized is unlikely to be consulted until a sense of discomfort or failure escalates to the status of a legal problem. As such, the contract cannot serve to facilitate an ongoing negotiation of terms which can be internalized into a commitment and a shared sense of venture purpose.

Participation in the decisionmaking process has long been recognized as a significant component of internalization of the decision and future commitment thereto.<sup>123</sup> If good relational contracting is likely to improve the quality of control and encourage moderation therein, it will be beneficial to encourage managers to accept, understand, and use the mechanisms and procedures created in the process. Yet, in practice, the participation in the contracting process which is likely to foster this goal is notably missing.<sup>124</sup> In their failure to participate in the joint venture contracting process, parents sacrifice an opportunity to help select more effective terms, which they are then more likely to understand and employ in the actual operation of the venture. Thus, even if the formulation process by which contractual terms are selected stumbles upon acceptable choices, there is a reduced likelihood that they will be implemented unless the venture managers know they exist and are committed to them.<sup>125</sup>

*Proposition 14.* The processes of learning and reconciling new information with existing strategies are fundamental to relational contracting. Rela-

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into the value systems or behavior systems of the parties. This internalization process occurs naturally as a result of group activity, such as real participation in an iterative and continually developing contracting process. For some classic discussions of the effect of group activity on cohesiveness and norm internalization, see I. JANIS, *VICTIMS OF GROUPTHINK: A PSYCHOLOGICAL STUDY OF FOREIGN POLICY DECISIONS AND FIASCOS* (1972); T. NEWCOMB, *PERSONALITY AND SOCIAL CHANGE: ATTITUDE FORMATION IN A STUDENT COMMUNITY* (1943); Asch, *Studies of Independence and Conformity: A Minority of One against a Unanimous Majority*, 70 PSYCHOLOGY MONOGRAPHS 9 (1955).

122. S. SALBU, *supra* note 65, at 181.

123. See *supra* note 121.

124. See S. SALBU, *supra* note 65, at 178.

125. Implementation of well formulated strategy can fail because the individuals expected to carry out its goals have not participated sufficiently in the formulation process, including the establishment of contractual expectations. Quinn emphasizes the usefulness of "highly adaptive learning interactions" in the creation of strategies characterized by acceptance and commitment. See J. QUINN, *supra* note 19, at 24. Highly adaptive learning interactions are relational in their development under conditions of meaningful participation of those who will implement the strategy. These interactions are unlikely to occur under classical contracting conditions typically characterized as lawyer-intensive.

tional contracting is in large part defined by its openness to learning and to the processing and incorporating of new information.<sup>126</sup> This is best explained by returning to the fundamental differences between classical and relational contracting.

Classical contracting is characterized by its adherence to the fundamental goals of discreteness and presentation. These two ends are in direct conflict with the incorporation of new information.<sup>127</sup> Discreteness is the quality in contracts wherein transactions are isolated, insular, and independent. No future relationship beyond the immediate, bounded transaction is assumed or anticipated. The purity of this sense of discreteness exists because the transaction is fixed and clearly bounded from other transactions or other information which may affect later transactions, but which cannot, under the definition, affect the stability effected by classical contract commitment. Likewise, presentation pins down the present and future values of promises so that planning and action can proceed within a context of risks which, in the ideal form, have been perfectly fixed and allocated. The role of learning is certainly limited within this context. Although information may be incorporated in the pursuit of other transactions and their contracting processes, new information is technically irrelevant to the present transaction under classical contracting assumptions.

Conversely, relational contracting can be defined in terms of learning as a mode of contract ideology which values the ability of parties to utilize new knowledge as it arises, and it alters the nature of the relationship between parties so as to utilize information and exploit learning opportunities. When Lorange emphasizes the importance of information, learning, and "knowledge packages,"<sup>128</sup> he emphasizes implicitly the need for relational forms of contracting and a more open conceptualization of the process.

## V. MODIFYING THE JOINT VENTURE CONTRACTING PROCESS

Together, the preceding propositions suggest a model for altering the manner in which joint venture contracting occurs, particularly under

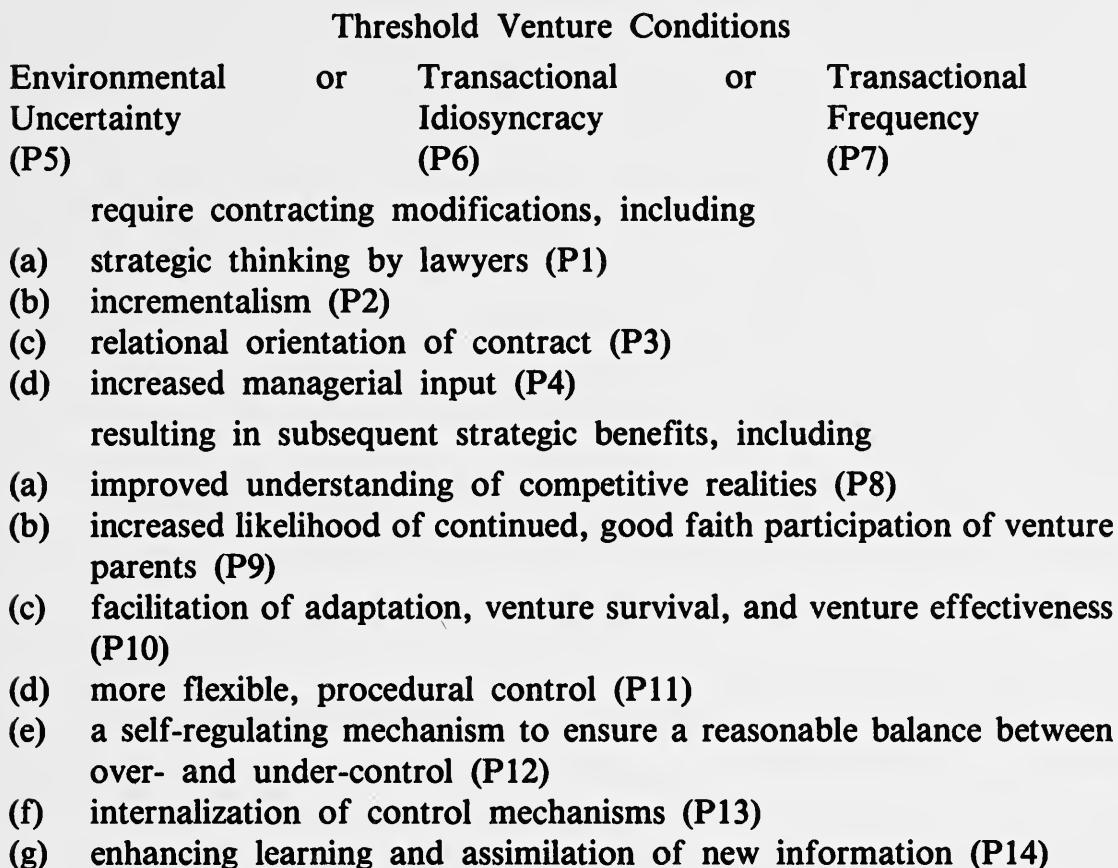
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126. See Macneil, *Contracts*, *supra* note 13, at 895. Macneil notes in regard to learning and adaptation in relational contracting that a "great deal of change in ongoing contractual relations comes about glacially, though small-scale, day-to-day adjustments resulting from an interplay of horizontally arranged exchange—e.g., workers creating new ways of cooperatively defining their work."

127. Cognitive theory regarding the assimilation of new information suggests that there are five basic stages of information processing: selective attention, encoding, storage and retention, retrieval, and judgment. Lord, *An Information Processing Approach to Social Perceptions, Leadership, and Behavioral Measurements in Organizations*, in 7 RESEARCH IN ORGANIZATIONAL BEHAVIOR 87 (L. Cummings & B. Staw eds. 1985). This model of processing information is more likely to be effective when discreteness and presentation of contract are minimized and the model is reiterative and developmental over time.

128. See Lorange, *Win-Win Strategies*, *supra* note 92, at 29.

conditions of volatility and environmental unpredictability.<sup>129</sup> The model organizes the fourteen propositions into three categories: (1) threshold venture conditions; (2) prescribed contracting modifications; and (3) subsequent strategic benefits. The model, discussed in detail in this section, can be visualized as follows:<sup>130</sup>



The threshold venture conditions are the primary, but not the exclusive, triggering situations for the prescribed contracting modifications. In accordance with Williamson's observations regarding transaction cost analysis,<sup>131</sup> these are the conditions under which classical contracting and concomitant traditions are least likely to be effective. Environmental uncertainty, transactional idiosyncracy, and transactional frequency are

129. Turbulent conditions are a possibility in any contractual situation; they are particularly relevant in the instance of joint venture contracting. The potential for conflict is increased in the venture form because the majority of these arrangements are "related" joint ventures in which the collaborating parent companies are competitors in extra-venture situations. See Pate, *Joint Venture Activity, 1960-1968*, 23 ECON. REV. 16 (1969), in which 520 joint ventures were studied and four-fifths were found to be horizontally or vertically related. The tension between cooperative and competitive roles makes the joint venture form of business particularly precarious.

130. "P" designations in the visual diagram of the model relate back to propositions as they are numbered in the text.

131. See Williamson, *Governance*, *supra* note 74, at 238-45.

venture conditions likely to be correlated with volatility and stochastic variation of assumptions.<sup>132</sup> The rigorous presentation of variables typical of classical contracting will exact high transaction costs as frequent and idiosyncratic modification of expectations is continually renegotiated.

Because the classical mode is suboptimal under these threshold conditions, contracting modifications are prescribed. Specifically, lawyers must think strategically, rather than in the classically legalistic fashion typically found in law school contract curricula. They must focus on adaptation and accept reasonable levels of uncertainty, ambiguity, and risk in drafting documents that will enhance relational development. To do this, they must understand the businesses they support<sup>133</sup> as well as the emergent strategies which occur naturally and are particularly desirable under the threshold conditions.<sup>134</sup> The effort to support emergent, incremental strategy will naturally entail a movement toward relational contracting because the two are analogous: the former managerial,<sup>135</sup> and the latter legal<sup>136</sup> in origin.

Hoping that lawyers will think strategically and support emergent strategy by employing relational contracting is idealistic and unrealistic unless assistance comes from the managerial ranks. Lawyers are not trained in relational contracting and are unaccustomed to viewing the nature of contracts except from a classical perspective,<sup>137</sup> but professionally trained managers are well versed in strategic theory.<sup>138</sup> In order to utilize lawyers strategically in the contracting process, managers must be significant participants whose frameworks of analysis can be shared with and assimilated by attorneys. This participation enhances the business-oriented quality of lawyers' work and brings managers into the process of contracting at a crucial point in the strategy formulation cycle.

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132. See Macneil, *Contracts*, *supra* note 13, at 886-99; Williamson, *Governance*, *supra* note 74, at 238-46.

133. The need for lawyers whose training and perspective are more relational than classical is supported by the trend toward utilization of in-house counsel whose knowledge of actual business practices is vital to the many nonlegalistic functions which lawyers serve.

134. See *supra* note 47.

135. See, e.g., Wrapp, *Good Managers Don't Make Policy Decisions*, 45 HARV. BUS. REV. 91 (1967).

136. See Macneil, *Futures*, *supra* note 15, at 691.

137. A typical textbook or treatise on contracts includes discussions of offer, acceptance, consideration, capacity to contract, mistake, conditions, breach, impossibility, remedies, third party rights, discharge, and illegality. Virtually all such treatises limit their analysis to classical (typically common law) and neoclassical (typically U.C.C.) concepts. See, e.g., E. FARNSWORTH & W. YOUNG, *CONTRACTS* (3d ed. 1980).

138. L. PORTER & L. MCKIBBIN, *MANAGEMENT EDUCATION AND DEVELOPMENT: DRIFT OR THRUST INTO THE 21ST CENTURY?* 47-87 (1988) (discussing in detail curricular requirements for accreditation of business programs by the American Association of Collegiate Schools of Business).

Adoption of these contracting modifications under conditions of environmental uncertainty, transactional idiosyncracy, and transactional frequency, can yield strategic benefits<sup>139</sup> by which lawyers operate to strengthen planning. The by-products of the recommended changes include development of advantage within a given industry,<sup>140</sup> enhancement of effectiveness,<sup>141</sup> efficiency,<sup>142</sup> job satisfaction,<sup>143</sup> and likelihood of survival.<sup>144</sup> Given that conditions of uncertainty and idiosyncracy characterize increasingly complex markets, the movement toward the proposed contracting modifications will be crucial. The resulting strategic benefits will help ensure the prosperity of the developing venture form as a mechanism of organizational adaptation for the future.<sup>145</sup>

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139. See *supra* note 130 (these benefits are listed as a-g, with referrals to relevant propositions throughout the text).

140. Understanding of competitive realities, a strategic benefit under Proposition 8, is vitally important in the process of jockeying for position within industries according to industrial organization literature. See M. PORTER, *supra* note 86, at 4.

141. Organizational effectiveness is usually defined in terms of goal achievement. For a discussion of this concept, see Cunningham, *A Systems-Resource Approach to Organizational Effectiveness*, 31 HUM. REL. 631 (1978); Perrow, *The Analysis of Goals in Complex Organizations*, 26 AM. SOC. REV. 854 (1961). The strategic benefits of contracting modifications are essential elements of organizational effectiveness.

142. Efficiency is generally conceived to be an economic concept wherein the production function is characterized by reduction of input and augmentation of output. See W. SCOTT, T. MITCHELL, & P. BIRNBAUM, *ORGANIZATION THEORY: A STRUCTURAL AND BEHAVIORAL ANALYSIS* 4 (1981). Efficiency can be effected by competitive environment, flexibility, control, and quality of information as enhanced by the prescribed contracting modifications.

143. Propositions 12 through 14 suggest that the prescribed contracting modifications help modulate levels of control while assisting in the internalization of norms and enhancing learning and assimilation of information. For discussions regarding the positive effects of mitigated control and enhanced autonomy and self-determination on worker satisfaction, see R. FORD, *MOTIVATION THROUGH THE WORK ITSELF* (1969); F. HERZBERG, B. MAUSER, & B. SNYDERMAN, *THE MOTIVATION TO WORK* (1959); R. MAHER, *NEW PERSPECTIVES IN JOB ENRICHMENT* (1971).

144. See Levine & Byrne, *supra* note 3, at 101-05 (joint venture survival is both a direct result of contracting modification under Proposition 10 and a natural result of increased industry advantage, effectiveness, efficiency, and job satisfaction).

145. See H. MINTZBERG & J. QUINN, *THE STRATEGY PROCESS* 735 (2d ed. 1991). Mintzberg & Quinn note that organizational design under increasing complexity should move from the traditional multidivisional form to "adhocracy," which is a less bureaucratically rigid form capable of incorporating emergent strategy more effectively than traditional structures. Organizational innovation which allows for more flexible systems of control can be incorporated into nontraditional arrangements like joint ventures and are more conducive to relational contracting and its benefits than more bureaucratic structure.



# Taking Harms Seriously: Involuntary Mental Patients and the Right to Refuse Treatment

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## INTRODUCTION

One of the more controversial, if not paradoxical, developments in the continually expanding field known as "mental health law"<sup>1</sup> has been the establishment in the mid-to-late 1960's of a patient's right to treatment,<sup>2</sup>

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1. In no field of law is the divisive, dualistic character of America's legal system more apparent than in the field known as mental disability law. There, legislatures, courts, and scholarly tradition have combined to produce an unwieldy amalgam of general principles and particularized provisions so riddled with internal conflict as to justify a diagnosis of florid legal schizophrenia. In this field of law, the state's *parens patriae* power competes with its police power; the patient's right to treatment coexists (all so uneasily) with the right to refuse it; the therapist's obligation to preserve client confidentiality militates against the duty to warn others; the psychiatrist's wish to treat is undercut by legal compulsion to deinstitutionalize or to refrain from institutionalization altogether; while the pressure on the provider/administrator toward early release increases the risk of legal liability; and the doctrine to deliver least restrictive treatment threatens the disabled with the reality of being subjected to a regimen that retains most of the coercion and restraints of the institutional setting, but without the treatment, or worse, of being left with the unfettered freedom to deteriorate and die in the streets.

Brakel, *Legal Schizophrenia and the Mental Health Lawyer: Recent Trends in Civil Commitment Litigation*, 6 BEHAV. SCI. & L. 3, 4 (1988).

2. *Rouse v. Cameron*, 373 F.2d 451 (D.C. Cir. 1966), is generally recognized as the first judicial articulation of the right to treatment. The concept was explicitly put forth as early as 1960 in an influential article by Birnbaum. Birnbaum, *The Right to Treatment*, 46 A.B.A. J. 499 (1960). The *Rouse* court based the availability of this right on closely related language in the District of Columbia's mental health code. However, subsequent court decisions in other jurisdictions had no trouble finding such a right in the absence of explicit or suggestive statutory language. The right was seen to be inherent in the "logic" of civil commitment and according to some courts, was even compelled by the state and federal constitutions. See, e.g., *Welsch v. Likins*, 550 F.2d 1122 (8th Cir. 1977); *Eckerhart v. Hensley*, 475 F. Supp. 908 (W.D. Mo. 1979); *Wyatt v. Stickney*, 325 F. Supp. 781 (M.D. Ala. 1971). The United States Supreme Court has never found a patient's treatment right to be constitutionally compelled. See *Youngberg v. Romeo*, 457 U.S. 307 (1982); *O'Connor v. Donaldson*, 422 U.S. 563 (1975).

followed a short decade later by the legal consolidation of its counter point — the right to refuse treatment.<sup>3</sup> Although legal rights advocates<sup>4</sup> may contend that there is no conflict between these two rights, the reality is that they often do conflict. The clash of interests is most pronounced in mental hospitals housing involuntarily committed patients,<sup>5</sup> where the very concept of right to refuse treatment seems anomalous and its unchecked assertion would wholly vitiate the purpose of the enterprise. In this setting, many treating psychiatrists find themselves cornered into an ethical and legal no-win position as they must watch patients, committed to their charges by the state because the patients are incapable of recognizing their need for treatment, fall prisoner<sup>6</sup> to this "liberty interest" they have chosen to exercise.<sup>7</sup>

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3. The leading cases here are *Rennie v. Klein*, 476 F. Supp. 1294 (D.N.J. 1979), *modified*, 653 F.2d 836 (3rd Cir. 1981), *vacated*, 458 U.S. 1119 (1982), and *Rogers v. Okin*, 478 F. Supp. 1342 (D. Mass. 1979), *aff'd in part, rev'd in part*, 634 F.2d 650 (1st Cir. 1980), *vacated sub nom.* *Mills v. Rogers*, 457 U.S. 291 (1982). The appeals and rehearings of these cases chipped away at the breadth and constitutional stature of this right, as compared to its initial articulations, though the general proposition that the right to refuse is available to mental patients remained intact. In some writings, the date of "discovery" of the right-to-refuse concept is pushed back to 1972 via a reference to *Canterbury v. Spence*, 464 F.2d 772 (D.C. Cir.), *cert. denied*, 409 U.S. 1064 (1972). However, this case is about informed consent to treatment, a doctrine of far longer standing that at best *implies* a right to refuse, and it does not involve a mental patient.

4. These advocates are often called, or label themselves as, patients' advocates. In our view, this is a misnomer because the uncompromising assertion (or creation) of legal rights frequently clashes with the patient's personal and medical interests.

5. The conflict may, of course, also arise in the treatment of voluntary patients, except that hospital personnel in that situation can mitigate the dilemma by discharging or threatening to discharge the refuser. By the same token, the assertion of the right to refuse can also undercut medical objectives in the outpatient clinic or the psychiatrist's office. Legally, the institutional psychiatrist's dilemma is that he is potentially liable if he treats and also if he does not. *See also infra* notes 36-37.

6. The term "prisoner" is no mere figure of speech here. A patient who refuses treatment will often extend the length of his confinement, thereby acting counter to his "liberty interest." Without treatment, he can only receive custodial care (*i.e.*, be "warehoused"), thus undercutting both his own and the institution's medical interests, not to mention society's interest in the efficient treatment of medical patients, particularly "public" patients. For the initial articulation of the view that to hospitalize a patient involuntarily, but not to permit treatment under the right to refuse, subjects the patient to preventive detention, see *Stone, The Right to Refuse Treatment: Why Psychiatrists Should and Can Make It Work*, 38 ARCHIVES GEN. PSYCHIATRY 358 (1981).

7. The "liberty interest" analysis is classic to right-to-refuse cases. It derives from the due process clause of the fourteenth amendment and was recently endorsed by the Supreme Court in *Washington v. Harper*, 494 U.S. 210 (1990), a case in which the institutional inmate's refusal was held to be properly overridden. Legal rights advocates may see this as an irony. In our view, the greater irony is how often the assertion of the liberty interest, in effect, decreases freedom.

In and of itself, the existence of a right to refuse unwanted medical treatment is not controversial and is clearly salutary. It is a right we presume to be accorded to all citizens—an indisputable element of the political and moral consensus in a society committed, such as ours, to democratic traditions limiting the power of the state and other external authorities. It is part of the premium we put on individual freedom, the liberty we possess to define and decide what is in our interests, our right to self-determination, personal autonomy, or even (and awkwardly) "personhood." These core values find expression in our contemporary legal culture under the rubric of one's "right to privacy"—a general, stretchable concept whose more particularized, and in our context, most relevant articulations include the "right to bodily integrity" or "freedom from bodily intrusions."<sup>8</sup>

Although the principle of personal inviolability thus commands us to respect an individual's medical treatment decisions in all "ordinary" situations,<sup>9</sup> exceptions must sometimes be made in unusual circumstances. For example, when the treatment offered or requested is experimental or presents a high risk, appropriate limits are placed on the individual's affirmative treatment choices. The same is true when the *refusal* to be

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8. Liberty, freedom, privacy, and autonomy are interwoven concepts that, judging from their articulation in court cases, seem more to feed on one another than to submit to any logical progression from primary to secondary or general to specific. Is it the right to privacy that creates the liberty interest or the other way around? Does the concept of personal autonomy foster various freedoms or do the acknowledged freedoms generate autonomy? The constitutional invocations for these concepts are equally confounding and range from specific clauses in the fourteenth amendment to fuzzier constitutional "penumbrae" from which the rights (e.g., "privacy") are seen to emanate. See *Griswold v. Connecticut*, 381 U.S. 479, 483 (1965). The specific right to bodily integrity or freedom from bodily intrusions derives from traditional tort law.

9. A favorite judicial quote here is from Justice Cardozo, who in *Schloendorff v. Society of New York Hospitals*, 211 N.Y. 125, 129, 105 N.E. 92, 93 (1914) wrote: "Every human being of adult years and sound mind has a right to determine what shall be done with his own body." The "sound mind" qualification is critical to our context. The qualification of adulthood is also relevant. Children are not competent under the law to make contractual or other decisions that have legal ramifications. In recent years, the law has vacillated between a hands-off and an interventionist approach as regards the *mental* treatment and commitment of minors, with the most recent trend favoring the former mode. See *Parham v. J.R.*, 442 U.S. 584 (1979). Legal interference is rare for the treatment of children's *physical* illnesses. Parents, in consultation with their physicians, routinely make these decisions on behalf of their children, unencumbered by legal process or even the thought of it. It is in cases when parents, out of religious conviction, have attempted to *withhold* treatment that the law has recognized a need to intervene. See, e.g., *Walker v. Superior Ct.*, 194 Cal. App. 3d, 222 Cal. Rptr. 87 (1986), *superseded*, 47 Cal. 3d 112, 763 P.2d 852, 253 Cal. Rptr. 1, *cert. denied*, 491 U.S. 905 (1989) (rejecting a Christian Scientist's defense that the "spiritual treatment" given to her four-year-old daughter who died of acute meningitis exonerated her from charges of involuntary manslaughter and child endangerment).

treated is life-endangering, amounting to a passive suicide decision. The possibility of serious, even fatal, harm to the patient is the unifying thread. The right to make one's own health choices is not absolute. One may (still) kill oneself slowly by smoking cigarettes or, as in some of our more freedom-loving states, live with the increased risk of instantaneous injury or death by not wearing a seatbelt while driving a car or protective head gear while riding a motorcycle. Yet, neither the law nor social morality presently condones the notion that people are free to kill themselves actively or to mutilate themselves severely.<sup>10</sup> Once a person becomes a client of the health care system, the idea that treatment choices may be circumscribed is reinforced by the doctor's professional ethic that he shall not harm his patient.

The "extraordinary" situation most relevant to our topic tends to be less extreme than the death-defying scenarios invoked above and involves balancing different values.<sup>11</sup> It is the situation when the individual needs standard medical intervention, but is, for one reason or another, incapable of asking for it (or incapable of resisting it, in instances when the treatment provider is willing or obligated to intervene in the absence of the individual's request or consent). There is no treatment decision issuing from the individual on which the treatment provider can act. A person who is comatose or who is otherwise overwhelmed by physical trauma cannot request or consent to medical treatment. In the mental health setting, "incapacity" usually means "incompetency." There is no treatment decision because the individual is mentally incapable of making it.

Much has been written about the meaning of "mental incompetency":<sup>12</sup> (1) whether its essence is clinical or legal or some mix of the two; (2)

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10. The so-called right-to-die cases, which are becoming increasingly prominent in law and in the public consciousness, turn on the assertion that the life of the individual who wishes to end it is (in the individual's view or that of a substitute decisionmaker) no longer worth living—an assertion that is debatable or litigable only in dire circumstances. See, e.g., *Cruzan v. Director of Mo. Dep't of Health*, 110 S. Ct. 2841 (1990); *In re Quinlan*, 70 N.J. 10, 355 A.2d 647, *cert. denied sub nom.* *Garger v. New Jersey*, 429 U.S. 922 (1976).

11. Some commentators and interested parties on either side of the issue nevertheless try to structure the debate in right-to-live/right-to-die terms. This misses the point and constitutes a gross exaggeration of the mental treatment issue. Even the more invasive interventions, such as psychosurgery (today virtually never performed) or ECT, are not of that order. For antipsychotic medication treatments, despite side effects that in isolated cases of misadministration have caused death, framing the issue as such is even less pertinent. See *Kaimowitz v. Department of Mental Health*, No. 73-19434-AW, slip op. (Cir. Ct. Wayne County Mich., July 10, 1973).

12. For an extensive treatment of the civil incompetency concept, see S. BRAKEL, J. PARRY, & B. WEINER, THE MENTALLY DISABLED AND THE LAW 369-433 (3d ed. 1985). Contemporary articulations of the incompetency concept threaten the capacity of the states to provide treatment for mentally ill persons. Given a rigid interpretation of the theory that

whether it stands for a general incapacity or one specific to the decisional situation at hand; (3) whether it is, or should be, presumed for all who certifiably suffer from a mental illness, for those institutionalized in mental hospitals, for those involuntarily hospitalized, or for none of the above; (4) if and when it is advisable to have a delegate for an incompetent person make substitute decisions for the latter; and (5) whether "incompetency" is merely a pragmatic concept for those who wish to exercise power over the alleged incompetent.

This Article does not attempt to resolve the preceding questions about the concept of competency. What is important for the purpose of our present analysis is that an individual's mental incompetency does not, except in isolated instances, wholly preclude him from articulating a treatment decision. In other words, in contrast to one who is silenced by physical incapacity, a mentally incompetent person can voice objection to treatment.<sup>13</sup> Based on this generalized presumption of retained capacity to speak, we can postulate the following minimal principle on which general agreement should be possible: All mentally-ill persons, irrespective of adjudicated or presumed incompetency, retain an initial right to articulate their objection to or refusal of unwanted treatment which should be heard. Beyond this principle, interests begin to diverge and opinions may differ. The crux of the controversy regarding treatment refusals by mentally ill persons is whether, when, how, and by whom an articulated refusal can be overridden.

Having identified what we believe is the true issue, we can supply the answer. We state it in the form of three basic contentions whose direct application is intended to be limited to situations when patients are in mental hospitals via involuntary commitment and when the proposed treatment is antipsychotic medication. We contend that in this situation: (1) the decision to override a treatment refusal is best made by medical personnel rather than judges or other legal functionaries;<sup>14</sup> (2) the override

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"incompetent" persons cannot give valid consent to voluntary hospitalization and treatment, the viability of the states' entire voluntary admission schemes is undermined. Persons who may wish to be hospitalized or who willingly sign voluntary admission and treatment papers, will instead have to be involuntarily committed—hardly the preferred approach. Worse, some of these persons, though seriously ill, may not meet the restrictive criteria for involuntary commitment and thus, could be left without any way to obtain treatment. For the proposition that hospital officials may even be legally liable when they extend "voluntary" treatment to such persons, see *Zinermon v. Burch*, 494 U.S. 113 (1990).

13. The unconscious patient will not object to treatment, but the delirious adult and many children, particularly small children, may. They may fight, scream, and voice inarticulately their "objection" to treatment. Indeed, not infrequently, patients need to be restrained for treatment to proceed. This has never been deemed a problem requiring legal intervention, nor should it be.

14. The mandate for judicial review of treatment refusals produces an especially

decision can be made in all circumstances, not, as presently conceded by the law and most legal advocates, only in emergencies; and (3) it can and should be made with minimal loss of time (even no loss of time if the basic treatment decision is made simultaneous with the commitment decision, as we propose the law should provide).<sup>15</sup> The objectives of and rationales for each of these contentions are interrelated. They defer to professional competency and perhaps more importantly, the need for timely treatment.<sup>16</sup>

Legal rights advocates are prone to dispute the above contentions on constitutional grounds. Rather than debate or litigate the straightforward question of what measure of patient autonomy is desirable and practicable in the mental hospital setting, the advocates' strategy has been to outflank the perceived "opposition" by redefining the issue in terms of "due process," "equal protection," or even "freedom of expression," often enveloping the analysis in the language of discriminatory treatment.<sup>17</sup>

This Article does not intend to join the debate on this level for the following reasons. We do not believe that the right to receive or to refuse treatment conundrum is likely to be solved by constitutional or other doctrinal analysis. Nor are treatment issues usefully conceptualized as problems in invidious discrimination. The heart of the problem, we believe, lies elsewhere. It is primarily factual. Its essence is in the law's apparent, and in some cases apparently willful, misunderstanding of the medical facts. As such, we believe its resolution will come principally through factual rectification.

### I. THE PERSISTENCE OF MEDICAL MISINFORMATION AND MYTHS IN THE LAW

Although a recent Supreme Court decision concerning the involuntary medication of a state prison inmate endorses a medical/administrative pro-

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anomalous result in cases in which the involuntary patient refuses medication upon admission. In that instance, a second trial must then be held which will be almost wholly duplicative of the commitment proceeding just completed.

15. This proposal will be elaborated in the final pages of this Article. For now, we want to point out that making the treatment decision simultaneous with commitment will not threaten the patient's opportunity to be heard, to object, or to refuse. To the contrary, the matter would be addressed explicitly and separately. In addition, the treatment decision would be subject to periodic administrative review, including at the patient's initiative.

16. These principles may have substantial applicability beyond the present context. See *supra* note 5. In addition, medical judgment deserves substantial deference with respect to treatment methods other than medication. *Youngberg v. Romeo*, 457 U.S. 307 (1982).

17. The first amendment freedom of expression link to the matter of forced medication may appear the most remote of the various constitutional strategies. For an extensive argument that it is the most appropriate link (a point, it should go without saying, we do not share), see Winnick, *The Right to Refuse Mental Health Treatment: A First Amendment Perspective*, 44 U. MIAMI L. REV. 1 (1989).

cedure for overriding decisions to refuse treatment,<sup>18</sup> it can hardly be concluded that the medical side has won the battle of what process best serves the treatment interests of mental patients. The Supreme Court has long been a voice in the wilderness on mental health matters, diverging sharply from other courts on both the state and lower federal levels.<sup>19</sup> State court holdings in particular continue to adhere to the orthodoxies of the legal decisionmaking model,<sup>20</sup> under which the provider's determination to override the patient's refusal will be subjected to judicial reassessment at any of a variety of junctures while little heed is paid to the individual and institutional harms that may result from the consequent delay.<sup>21</sup> At the

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18. *Washington v. Harper*, 494 U.S. 210 (1990). In this case, the Court approved the State of Washington's Special Offender Center policy that an inmate may be involuntarily medicated upon the order of a psychiatrist if he is found to suffer from a mental disorder and to be gravely disabled or dangerous. Rejecting the legal decision model urged by the inmate and found to be constitutionally required by the state supreme court, the Court held the Center's administrative review procedures to be constitutionally sufficient. The essence of these procedures was a timely hearing and subsequent periodic review by an in-house special committee composed of a psychiatrist, a psychologist, and a corrections official. The decision's import for the mental health care setting is not altogether clear. Prisoners, to the extent they retain "autonomy" rights, which they do up to a point, retain somewhat different ones than do involuntary mental patients. In terms of the state's interest, forced treatment on the ground of security considerations may be more compelling for prisoners. On the other hand, involuntary treatment of mental patients is logically supported by the rationale of commitment and the objectives of mental institutionalization. If the medical decision model is appropriate for corrections, can it be wrong for mental health?

19. See, e.g., *Youngberg v. Romeo*, 457 U.S. 307 (1982); *Parham v. J.R.*, 442 U.S. 584 (1979). *Parham* and *Romeo* had a great deal to do with the outcome in *Harper*. The fact that *Harper* itself was a reversal of a decision by Washington's highest court is also telling. Finally, the three dissenters in *Harper*, Justices Stevens, Brennan, and Marshall, would have sustained the Washington Supreme Court's requirement for a judicial hearing. Their opinion reflects an overestimation of the dangers and discomforts of drug treatment mixed with legitimate points about the lack of independence of the institution's review mechanism and the unhealthy "muddling" of therapeutic and security rationales in the forced medication of inmate Harper.

20. The federal district and circuit courts are by design more prone to follow the lead of the United States Supreme Court than are the state courts, especially on minimum standards which the states are free to exceed. Evidence of this is detectable in the appellate courts' response to the initial decisions in *Rennie v. Klein*, 653 F.2d 836 (3rd Cir. 1981), *vacated*, 458 U.S. 1119 (1982) and *Rogers v. Okin*, 634 F.2d 650 (1st Cir. 1980), *vacated sub nom. Mills v. Rogers*, 457 U.S. 291 (1982). However, the most significant implementation of the Supreme Court's stance was presented in *United States v. Charters*, 863 F.2d 302 (4th Cir. 1988), *cert. denied*, 110 S. Ct. 1317 (1990), which upheld the medical-administrative procedures for ordering the forced medication of an involuntarily committed psychiatric patient who was unfit to stand trial.

21. Describing and documenting these harms is a major aspect of the remainder of this Article. For a listing of state and federal court decisions on the right to refuse treatment and a discussion of the general tenor of the law, see Brooks, *The Right to Refuse Antipsychotic Medications: Law and Policy*, 39 RUTGERS L. REV. 339 (1987). For another discussion by

same time, the legal literature<sup>22</sup> has continually shown a one-sided preoccupation with the "invasive" nature of mental treatment and medication and its potentially deleterious side effects,<sup>23</sup> while down-playing, if not outright ignoring, its documented benefits.<sup>24</sup>

When one combines the traditional inertia of law with the fact that the recent Supreme Court holding in *Washington v. Harper*<sup>25</sup> does no more than sustain a minimum constitutional standard for making the override decision in the prison setting, it is apparent that no real conciliation has been achieved between medical and legal rights and that none can be assumed to be forthcoming. The prospect of entrenchment or re-trenchment is real. Free to impose far more onerous standards for overriding patients' refusals, state courts and legislatures, influenced as in the past by a steady stream of medical misinformation and myths, can be expected to follow their institutional inclination to continue to "be legal" the process.<sup>26</sup>

The purpose of this Article is to show that a retreat from the Supreme Court's recently approved standard is neither necessary nor desirable. By relieving the legal community of the popular cant that institutional psychiatrists are gleefully engaged in a "therapeutic orgy"<sup>27</sup> that is over-

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the same author, see Brooks, *The Constitutional Right to Refuse Antipsychotic Medications*, 8 BULL. AM. ACAD. PSYCHIATRY & L. 179 (1980).

22. The value of the Brooks contributions lies in part in their relatively even-handed handling of the issue as compared to the treatment accorded to the mental treatment/refusal topic in most legal journals. We suppose that legal rights activist lawyers will find equal bias, in the opposite direction, in most medical publications. See *supra* note 21.

23. For the proposition that the side effects are really just "effects" and that the label "side" is used to diminish their significance or seriousness, see Winnick, *supra*, note 17. To assess the probity of this point, the reader might consider that the same thing can be said of more familiar drugs.

24. As with harms, a major objective of this Article is to document the benefits.

25. 494 U.S. 210 (1990).

26. When the Supreme Court took away the federal constitutional rationale for requiring full legal due process in treatment decisionmaking, a number of state courts responded by grounding the judicial process mandate for overriding treatment refusals on state statutory and common law or on the state constitution. See *Rogers v. Commissioner of the Dep't of Mental Health*, 390 Mass. 489, 458 N.E.2d 308 (1983); *Rivers v. Katz*, 67 N.Y.2d 485, 495 N.E.2d 337, 504 N.Y.S.2d 74 (1986); *State ex rel. Jones v. Gerhardstein*, 135 Wis. 2d 161, 400 N.W.2d 1 (1986), *aff'd*, 141 Wis. 2d 710, 416 N.W.2d 883 (1987). State judges and legislators will presumably feel equally free to circumvent the implications of *Washington v. Harper*. For general comments on lawmakers' inclination to solve social problems with law and legal process, see R. SLOVENKO, PSYCHIATRY AND LAW, 221 (1973); Brakel, *Response to James Ellis*, 23 L. & SOC. REV. 961 (1989); Brakel, *Pro Se*, 14 STUDENT LAW. 38 (1986).

27. See Plotkin, *Limiting the Therapeutic Orgy: Mental Patients' Right to Refuse Treatment*, 72 NW. U.L. REV. 461 (1978). This is one of the most frequently cited writings in right-to-refuse cases and other legal commentary on the subject. The article starts off by speaking of mentally ill persons as being "arrested and confined for 'treatment.'" *Id.* It then

whelmingly harmful in effect, and showing that the benefits of medication treatment are immense, indisputable, and capable of being delivered in a way that is largely risk-free for most patients, we hope to persuade decisionmakers that the patients' treatment interests can be served without the maintenance of a cumbersome and counterproductive legal-safeguard machinery. Faith in the law's capacity to render appropriate treatment decisions is misplaced. The law can only curb medical abuse. Too often the legal mind equates this with the assumption that there is abuse. Although never justified, this see-only-evil, hear-only-evil attitude is particularly inappropriate and destructive in today's mental health services environment. More than any previous time in psychiatry's history (and with due credit to the legal rights side for its role in fostering a new vigilance),<sup>28</sup> we believe that the contemporary law can safely afford to give a measured deference to the good faith, professional ethics, and professional competence of treating doctors.

## II. SEPARATING MYTH FROM REALITY: THE EMPIRICAL-MEDICAL PERSPECTIVE

Our purpose is to focus on the empirical aspect of the right-to-refuse question and to present medically accurate information on the benefits and risks of drug treatment and the harms resulting from no treatment. This information shapes the consensus medical perspective on the right to refuse treatment. It should also be the basis for any and all *legal* perspectives, but unfortunately, it is not.

We have reviewed the legal literature on the use of psychotropic drugs in detail, and we find that almost all of it is not merely biased, but also factually incorrect. Of the more than thirty law journal articles we examined, at least twenty would by any objective criterion be classified as vitriolicly "antidrug."<sup>29</sup> The remainder are somewhat more tempered,

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goes on to assert that "while *incarcerated*, they are subjected to a veritable orgy of 'therapeutic techniques' imposed upon them without their consent and often against their will by state-employed physicians." *Id.* (emphasis added). For a typical court case echoing this unmodulated antipsychiatric perspective, see *Davis v. Hubbard*, 506 F. Supp. 915 (N.D. Ohio 1980).

28. Notwithstanding our view that law at the so-called cutting edge of mental health is too often based on worst case scenarios, refuses to acknowledge that the general scenario is not nearly so bad or is much improved, and as a result, goes too far in legally inhibiting the mental health care provider, the aggressive advocacy of legal rights must nevertheless be credited with directly or indirectly fostering needed correctives in perspective, policy, and procedures. For a brief discussion of this dialectic quality of legal reform in the area of corrections, see Brakel, *Prison Reform Litigation: Has the Revolution Gone Too Far?*, 70 JUDICATURE 5 (1986).

29. Few put the bias as unabashedly in the title as Plotkin, but the content is no less slanted. See *supra* note 27. In addition, there is an equally voluminous law journal

but even these, with a few exceptions, are fundamentally slanted against the use of drugs in psychiatry. Factual inaccuracies abound and, as the writings rely almost exclusively on one another, they merely repeat spurious myths, piling misinformation on top of misinformation.<sup>30</sup> In addition, there is almost no consideration of the "helping" rationale behind psychiatric treatment or an acknowledgment of the obvious legal conundrum of how the state can justifiably hospitalize a patient against his will without providing effective treatment.

The judicial opinions are only marginally better balanced.<sup>31</sup> Too often they share the internal-referencing flaws of the reviews, with judges relying

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literature that is antipsychiatric in general, as opposed to antidrug. In *Dautremont v. Broadlawn Hospital*, 827 F.2d 291 (8th Cir. 1987), the phrase "mental restraint" is used in connection with drug treatment. In most articles, drugs are said to be "intrusive." The word intrusive suggests unwarranted entry into someone's mental life, presumably for punitive purposes or subjectively unpleasant effect. This is a pejorative term much like referring to surgery as butchery. The word "drugged," which is used frequently, has the connotation of heavy sedation.

30. Initially, several medically inaccurate law review articles were published based on snippets of data found in studies that came to diametrically opposite conclusions than the ones proffered by the legal writers. See, e.g., DuBose, *Of the Parens Patriae Power and Drug Treatment Schizophrenia: Do the Benefits to the Patient Justify Involuntary Commitment?*, 60 MINN. L. REV. 1149 (1976); Plotkin, *supra* note 27; Plotkin & Gill, *Invisible Manacles: Drugging Mentally Retarded People*, 31 STAN. L. REV. 637 (1979). These misrepresentations were then quoted by authors of subsequent law review articles or incorporated into court discussions. This resulted in the consideration of a succession of factually erroneous materials by both legal academics and legal practitioners. Virtually no one read and correctly summarized the original medical literature. The problem is that most legal libraries do not carry medical books and journals; therefore, the medical information about the risks and benefits of drugs and practical information about the context and consequence of their use is unavailable to most lawyers. There is also a "communications gap" compounding the availability problem. It is not so much (or not only) that the medical information is written in jargon, but that the implications of the information may not be readily understood by nonmedical readers. References to "mean improvement scores" and the like are not well-tailored to express the full human significance of the changes to the patients. The suggestion, implicit above, that the psychiatric profession shares some of the blame for the lack of information, that its complaint is in part a self-inflicted problem, is further strengthened by the fact that psychopharmacology was and remains a developing science in which many psychiatrists and psychologists are not well versed. The legal system may at times have had inadequate, perhaps even incorrect, input from the mental health community. Occasional commissions of both lawyers and psychiatrists have been appointed to review the psychopharmacological literature. Yet, with the persistence of elements in the psychiatric community unschooled in this specialty, or apathetic or even unsympathetic to its potential and achievements, it is quite possible that these reviews have served only to contribute to the information gap. See *infra* note 45.

31. Judges, particularly trial judges, are bound in theory by the facts presented in the case before them and not by the literature. However, judicial "facts" are not facts in the ordinary sense. They may include, in addition to the parties' allegations about specific events, practices, or procedures, a wide range of conclusions based on direct testimony by

not on original medical data, but on the self-perpetuating "interpretations" of the data in the legal literature.<sup>32</sup> Unique to the common-law system

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experts, the "facts found" in other legal cases, and personal or so-called common sense perspectives and assumptions of which judges may simply take "judicial notice." Thus, it is possible for a case to state the following: "Such widespread use of psychotropic drugs . . . is not, however, necessarily supported by any sound medical course of treatment. Put simply, the testimony at trial *established that the prevalent use of psychotropic drugs is countertherapeutic and can be justified only for reasons other than treatment—namely, for the convenience of the staff and for punishment.*" *Davis v. Hubbard*, 506 F. Supp. 915, 926 (1980) (emphasis added). This case also states that "the inmates' principal interest affected in the present case arises not from the state's attempt to punish thoughts but its attempt to use treatment *as a means of controlling thought, either by inhibiting an inmate's ability to think or by coercing acceptance of particular thoughts and beliefs.*" *Id.* at 933 (emphasis added). Mixed in with these "findings" are references to the most vociferous antipsychiatric legal literature, including Plotkin, and a cite to *Rennie v. Klein*, 476 F. Supp. 1294, 1299 (D.N.J. 1979) for the proposition that "drugs may cause cancer." *Davis*, 506 F. Supp. at 928. The Fourth Circuit's decision in *United States v. Charters*, 863 F.2d 302 (4th Cir. 1988), *cert. denied*, 110 S. Ct. 1317 (1990), was preceded by a decision of a panel of the same court which endorsed the traditional judicial review model and supported this result with a great deal of antidrug invective similar to the *Davis* opinion. See *United States v. Charters*, 829 F.2d 479 (4th Cir. 1987).

32. This produces statements such as the one in an *amicus curiae* brief in *Okin v. Rogers* that patients are "forcibly drugged into a physical stupor to prevent these activities. . . . [C]hlorpromazine . . . produced . . . a marked lack of interest in what was going on. . . . [I]t is difficult for patients so sedated that they can only sleep . . . to become members of the community again. . . . [P]henothiazines . . . decrease learning performance." Mental Health Association, Civil Liberties Union of Massachusetts Amicus Brief at 45-46, *Okin v. Rogers*, 134 F.2d 650 (1st Cir. 1977) (No. 77-1201). In addition, the court in *Rennie v. Klein*, 476 F. Supp. 1294, 1299 (1979), *modified*, 653 F.2d 836 (3d Cir. 1981), *vacated*, 458 U.S. 1119 (1982), noted that "drugs inhibit a patient's ability to learn social skills needed to fully recover from psychosis." A further extended quote gives one a flavor of the right-to-refuse treatment movement's thinking on antipsychotic medication:

[D]rugs are the most painful, distressing ordeal they have ever experienced — in a different class than prolonged solitary confinement or physical deprivation. . . .

The drugs can, however, cause a permanent psychotic condition. . . .

Physiologically, antipsychotic effects cannot be confidently distinguished from crude measures—such as bleeding, purging, and, in all probability, lobotomy—which render individuals too weak or preoccupied to attend to their psychotic urging. . . .

[M]ost acute psychotic episodes abate . . . without drugs. . . . Drugs are remarkably effective restraining devices . . . .

Drugs also ease the burden of the custodian's remaining tasks . . . . [In the past] staff accompanied every restrained or secluded patient to the bathroom; if patients could not leave their rooms, staff had to clean up after patients who soiled themselves. . . . By contrast, drugged patients are generally ambulatory . . . . They can walk to the dining room, en masse, feed themselves, return to their quarters and relieve themselves. . . .

This psychological state, induced in confinees, must be every overweening jailer's ideal. . . .

is the insidious possibility that the unsubstantiated allegation of today's case becomes tomorrow's generally established "legal fact." For example, in *In re the Mental Commitment of M.P.*,<sup>33</sup> a well-known case used in psychiatric circles, the Indiana Supreme Court opined that "[a]t the heart of this case is the virtually undisputed allegation that a person medicated with antipsychotic drugs has a 50% risk of contracting tardive dyskinesia."<sup>34</sup> No more than a year later, this assertion prompted an Illinois appellate court to bolster its decision invalidating a trial court-approved medication plan with the "fact" that "[t]he Indiana Supreme Court found that a person medicated with antipsychotic drugs has a 50% risk of contracting tardive dyskinesia in addition to other unpleasant side effects."<sup>35</sup>

These errors of fact and reasoning are no mere abstract concern. We are not just dealing with a dissonance in interprofessional metaphysics. The errors have real consequences. They affect the content of legal

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Private facilities that routinely bound, shackled, restrained, benumbed, or secluded the mentally ill would be intolerable today, because the state jealously guards its monopoly on physical force. Thus, shifting custody from public to private institutions, depended on the invention of a treatment form that made private management of mental illness consistent with evolving general norms about physical force and restraint. What private custodians cannot be allowed to accomplish with physical restraint, they can do even more efficiently by drugging . . . .

Clinical state psychiatry's "paradigm"—if that is the appropriate term—is "political," however, in a number of respects. . . . The apparent motivation is to maximize drugging because of the drugs' custody-enhancing effects—a political rather than a scientific objective. Its reduction of individuals to fungible entities without distinguishing characteristics, its tolerance for state-induced distress, and its apparent willingness to conceal the truth bespeaks political overreaching more than scientific or professional error. . . .

Doctors lying to patients, their infliction of serious drug harms, and their affronts to patient dignity can be checked by court decree.

Gelman, *Mental Hospital Drugs: Professionalism and the Constitution*, 72 GEO. L.J. 1725, 1744-64 (1984).

33. 510 N.E.2d 645 (Ind. 1987). At the time of this case, quantitative data on the development of tardive dyskinesia (TD) fell short of acceptable standards of precision and reliability. However, it is known with substantial certainty that there is almost no risk for short-term patients, a category that describes the overwhelming majority of patients. We also know that the risk goes up when high-dose medication is continued over the longer-term (generally defined as beyond six months). A reasonable estimate, based on preliminary research findings, is that the risk of developing TD increases about three percent per year. Thus, a patient who has received medications for an aggregate span of three years has a 9% risk and a 15% risk after six years. The 50% risk "found" by the Indiana and Illinois courts for mental patients, undifferentiated by the length of drug treatment, would in fact apply only to patients who are well into their second decade of continuous medication. See *infra* note 106 and accompanying text.

34. *M.P.*, 510 N.E.2d at 646.

35. *In re Orr*, 176 Ill. App. 3d 498, 513, 531 N.E.2d 64, 74 (1988).

representation provided to patients. They determine the practical outcomes to the patients who are covered by the courts' rulings, either as direct parties or far more broadly, as the indirect "beneficiaries" of the litigant class. They turn the right to refuse into a proverbial double-edged sword, one edge of which is capable of cutting deeply into the treatment rights and needs of patients, their families, and professional care providers. Both lawyers and psychiatrists can profit from trying to understand their differing professional philosophies and perspectives. These differences are real, perhaps profound, and are not easily reconciled. Yet, differences in values can never be bridged if the facts are ignored or misstated.

We will describe the risks and benefits of psychotropic drugs based on well-controlled, verified, and verifiable investigations. Factual information cannot tell us how the law should balance values in conflict, but wrong facts can result in bad law. The translation of the abstract right-to-refuse issue into real world treatment refusals has consequences which are vastly more serious and more complicated than the law and legal literature presume. We argue that a lawyer in possession of the medical facts cannot maintain the fiction that liberty is best protected by a legal philosophy—whether perceived as liberal or conservative—that holds the right to refuse treatment as the patient's paramount right.

#### *A. Reality of the Patient's Setting*

Apart from the mythology surrounding medical treatments for psychiatric patients, there is a second operating myth that determines the predominant legal stance toward right-to-refuse cases. This second myth concerns the type of mental patient for whom the right to refuse is at issue and how and why the patient finds himself in the setting. Both myths need to be undone before members of two diverse professions can come to a mutual understanding or agreement on what is best for patients. We deal briefly with the second myth first, before devoting the remainder of the Article to the issue of psychotropic drugs.

Most right-to-refuse cases arise among patients who have been involuntarily hospitalized. Voluntary patients who do not wish to cooperate with the prescribed treatment regimen can simply leave the hospital against medical advice or be discharged if they want to maintain the untenable position of wishing to stay while rejecting the course of treatment decided upon in the doctor's best medical judgment.<sup>36</sup> Outpatients can simply

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36. More significant perhaps, is the empirical evidence that treatment refusals among voluntary patients are qualitatively different than the refusals of involuntary patients. A 1980 study by Applebaum & Gutheil found that voluntary patients may resist treatment for a variety of reasons, but that the disagreements are usually resolved easily and quickly. See Applebaum & Gutheil, *Drug Refusal: A Study of Psychiatric Inpatients*, 137 AM. J. PSYCHIATRY

refuse to take their medication.<sup>37</sup>

For involuntary patients, there should be no illusions about the true nature of their commitment (*i.e.*, how and why it took place).<sup>38</sup> A court ordered them to be admitted to a psychiatric hospital, based on legal standards, substantive and procedural, that today are quite exacting.<sup>39</sup> They were found to either be so disabled as to pose a grave risk to their own well-being or so dangerous as to present an imminent threat to others. No alternative disposition less restrictive than hospitalization was deemed safe or available, or if available and offered to the patient, was not accepted by him. In personal terms, the patient's relatives felt hospitalization to be the only recourse, a judgment in which the family physician or other treatment provider almost certainly concurred. By contrast, the patient was unable to recognize his illness and his need to be hospitalized. It would not be unusual for him to be distrustful of, or even overtly angry at, those concerned about his mental health. Clinically, the patient's picture would be as follows: the patient suffers from a major mental illness (schizophrenia, mania, or psychotic depression, often with suicidal tendencies), is delusional and clinically incompetent, and has a history of repeated hospitalizations with an institutional record of psychotic episodes including violence against himself or others frequently matched by a similar

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340 (1980). Only a small minority of voluntary patients are persistent refusers. By contrast, the typical involuntary patient who rejects treatment does so out of persistent delusions about the treatment which are difficult to dispel. *See infra* note 41.

37. One of the drawbacks of outpatient care of mental patients is that many do not take their prescribed medication regularly or stop taking it altogether. As a result, both legal and medical practice have moved toward compelling previously hospitalized patients to continue with their medication via discharge that is conditioned on their doing so, with rehospitalization to occur if they violate the condition. For outpatients under such legal compulsion, the decision to refuse to comply begins to resemble in its legal and clinical consequences, the situation of the involuntarily committed treatment refuser. In addition, the concern about side effects such as TD is real for the outpatient who remains under such compulsion for the long term.

38. If flaws are perceived in the commitment of a particular individual or in the commitment process, there are legal avenues for a direct challenge. To use the right-to-refuse concept as the linchpin for such challenges is, if nothing else, strategically unsound in that it produces a range of undesirable effects for the psychiatric treatment system and for patients who are ordered to be treated by the system.

39. We permit ourselves an understatement here. The evidence is abundant that the commitment laws today are overexacting and leave many individuals who desperately need treatment untreated because the law, as interpreted by judges and sometimes even by treatment providers, does not permit their commitment. The rise in the number of homeless people on our streets and in our parks, many of whom are overtly psychotic, is not unrelated. For some insights into this relationship, see Brooks, *Law and Ideology in the Case of Billie Boggs*, 26 J. PSYCHOSOCIAL NURSING & MENTAL HEALTH SERV. 22 (1988) (analyzing the case of Joyce Brown/Billie Boggs, particularly the trial judge's opinion ordering her release).

free world history.<sup>40</sup> This is the context in which we should view the pros and cons of the right to refuse.<sup>41</sup>

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40. Involuntary patients tend to be much sicker than voluntary patients. The formers' illnesses progress to a point where they—and only they—fail to recognize their need for help. From time to time the assertion (and it is no more than an assertion, though a quite tenacious one), surfaces that mentally ill patients are no more dangerous than the general population. See, e.g., Note, *Developments in the Law: Civil Commitment of the Mentally Ill*, 87 HARV. L. REV. 1190 (1974). Usually invoked in support of the assertion is a disparate set of studies on varying population groups (hospitalized and nonhospitalized, voluntary and involuntary, and even criminal offenders with mental disabilities) that use widely diverging definitions of dangerousness and unmatching methodologies for detecting or measuring it. Most studies capture only the most conspicuous expressions of dangerousness—those which come to the attention of enforcement authorities, as reflected in the number of arrests and convictions. They do not capture the bulk of dangerous conduct that leads to rehospitalization or that bypasses the criminal justice system and the violent, overtly threatening or self-destructive behavior that occurs in the “private” realm of family, friends, or fellow patients. Finally, the studies are old and would, irrespective of their relevance, credibility, or inclusiveness at the time the data were collected, have little to say about the characteristics of contemporary populations hospitalized under today's restrictive commitment laws. The results of more recent studies tend to belie the sanguine conclusions of the earlier research. See, e.g., Brakel, *Sampling The Mental Health Law Literature: Three Recent Books*, 1981 AM. BAR FOUND. RES. J. 535 (all assessments of dangerousness involve a heavy, but usually hidden, “political” judgment component); Lagos, Perlmutter, & Saexinger, *Fear of the Mentally Ill: Empirical Support for the Common Man's Response*, 134 AM. J. PSYCHIATRY 1134 (1977); Sosowsky, *Crime and Violence Among Mental Patients Reconsidered in View of the New Legal Relationship Between the State and the Mentally Ill*, 135 AM. J. PSYCHIATRY 33 (1978); Zitrin, Hardesty, Burdock, & Drossman, *Crime and Violence Among Mental Patients*, 133 AM. J. PSYCHIATRY 142 (1976). A recent study, open to a variety of interpretations, is Hiday, *Dangerousness of Civil Commitment Candidates: A Six-Month Follow-Up*, 14 L. & HUM. BEHAV. 551 (1990). Much of its value lies in its demonstration of the definitional problem and the many indicators bearing on dangerousness.

Among the involuntary committed populations today, there may occasionally be persons with diagnoses such as multiple personality, various brief reactive psychoses, or any number of other states of lesser severity in personality disorganization or acuteness. Consensually, medication treatment would not be appropriate in such cases, and the idea that it would be routinely prescribed either in private or public hospitals is simply false.

41. There is persuasive evidence that the treatment refusals among the involuntarily committed population are a direct and persistent consequence of major mental illness. See Ciccone, Tokli, Clements, & Gift, *Right to Refuse Treatment: Impact of Rivers v. Katz*, 18 BULL. AM. ACAD. PSYCHIATRY & L. 203 (1990) [hereinafter Ciccone, *Right to Refuse*] (concluding from an empirical study of two samples that “the reasons for refusing medication were rarely independent of an ongoing psychosis”). In general, most empirical studies find treatment refusers to be seriously ill patients who refuse because of denial of their illness or delusional thought about medication. See Bloom, Faulkner, Holm, & Rawlinson, *An Empirical View of Patients Exercising Their Right to Refuse Treatment*, 7 INT'L. J.L. PSYCHIATRY 315 (1984) [hereinafter Bloom, *An Empirical View*]; Young, Bloom, Faulkner, Rogers, & Pati, *Treatment Refusal Among Forensic Inpatients*, 15 BULL. AM. ACAD. PSYCHIATRY & L. 5 (1987).

*B. Treatment and Drugs: A General Description of the State of Medical Art and Research Today*

What can be done for these patients? Formerly, not much. The better hospitals may have provided decent physical care and custody, but little effective treatment. That has changed dramatically, however, with the advent of the so-called psychopharmacological revolution—a revolution we feel it would be tragic to reverse because of some presumed legal “liberty interest” that would allow the patients most in need of its benefits (as so certified by the legal system itself) to refuse them.

Medicine has developed a methodology for the evaluation of drug treatment in general medicine, pediatrics, and surgery. The same methodology is used in drug evaluation for psychiatric treatment. Although psychiatric theory can be “speculative,” with different experts giving different theories, drug evaluation is markedly different in that it is objective, empirical, unbiased, and stringently regulated by the federal Food and Drug Administration (FDA).<sup>42</sup> Current, well-controlled studies show the dramatic value of treatment with antipsychotic medication. In the note below, we give a selective sampling of the writings and reports of many studies that form the basis for the textual discussion.<sup>43</sup>

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42. The FDA requires that any new medical drug or device be proven safe and effective before it is marketed. This means that the producing company must provide data from controlled, objective studies. In the case of drug manufacturers, this means “double blind” studies often involving thousands of patients conclusively showing that the new drug is superior to placebo or comparison medication. These drug trials are conducted under the threat of inspection by FDA officials. In anticipation of FDA audits, representatives of the sponsoring drug companies monitor the trials to insure that they are done in compliance with the FDA’s exacting requirements. The FDA takes legal action against investigators who violate the prescribed procedures. Many other countries where modern psychotropic drugs are used have similar validation procedures. Given this multiple review process of trials involving large numbers of subjects, the safety and efficacy of the drugs can be said to be established beyond a reasonable doubt, a legal standard that by the law’s own measure can be fulfilled by a single credible witness testifying in open court.

Some have charged that the operational mechanics of antipsychotic drugs are not well understood, suggesting that the theory on how the drugs work is no more robust than psychotherapy theory. In fact, we do know how the drugs affect the biological processes of the brain, though our understanding of the biological causes of mental illness and why the drugs improve the functioning levels of schizophrenics or patients with other serious mental illnesses is limited. Nevertheless, the conclusion that the drugs work is beyond dispute.

43. See M. GREENBLATT, M. SOLOMON, A. EVANS, & G. BROOKS, *DRUG AND SOCIAL THERAPY IN CHRONIC SCHIZOPHRENIA* (1965) [hereinafter M. GREENBLATT]; L. GRINSPOON, J. EWALT, & R. SHADER, *SCHIZOPHRENIC PHARMACOTHERAPY AND PSYCHOTHERAPY* (1972) [hereinafter L. GRINSPOON]; D. KLEIN & J. DAVIS, *DIAGNOSIS AND DRUG TREATMENT OF PSYCHIATRIC DISORDERS* (1st ed. 1969); P. MAY, *TREATMENT OF SCHIZOPHRENICS: A COMPARATIVE STUDY OF FIVE TREATMENT METHODS* (1968); G. PAUL & R. LENTZ, *PSYCHOSOCIAL TREATMENT OF CHRONIC MENTAL PATIENTS* (1977); Cole, Goldberg, & Davis, *Drugs in the Treatment of*

The placebo trial is the research methodology of choice for controlled studies. It is generally considered unethical to continue placebo clinical trials of acutely ill patients for longer than six weeks, which limits the "hard" data on the benefits of drugs. However, we know on the basis of more naturalistic longitudinal studies, anecdotal information, and individual case histories, that drug-induced improvements continue for several weeks or even months. The best data on the efficacy of the drugs are, of course, from the controlled studies. There are other sources of usable information, however, including: (1) institutional treatment practices; (2) the reports of uncontrolled clinical trials; and (3) reports from individual psychiatrists on their day-to-day practices. We focus first on this "softer" information to help set the practical context, including the history of the drug revolution in psychiatry.

Today, antipsychotic drugs are used throughout the world as the preferred treatment for schizophrenic, manic, and psychotically depressed

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*Psychosis*, in PSYCHIATRIC DRUGS 153 (P. Solomon ed. 1966) [hereinafter Cole, *Drugs*]; Davis, *Recent Advances in Pharmacologic Treatment of the Schizophrenia Disorders*, in PSYCHIATRY 1982 ANNUAL REVIEW 178 (1982); Davis, *Important Issues in the Drug Treatment of Schizophrenia*, 6 SCHIZOPHRENIA BULL. 70 (1980); Davis & Chang, *A Look at the Data*, in CONTROVERSY IN PSYCHIATRY, 595-660 (J. Brady & H. Brodie eds. 1978); Davis, Janicak, Chang, & Klerman, *Recent Developments in the Drug Treatment of Schizophrenia*, 133 AM. J. PSYCHIATRY 208 (1976); DuBose, *Of the Parens Patriae Commitment Power and Drug Treatment of Schizophrenia: Do the Benefits to the Patient Justify Involuntary Treatment?*, 60 MINN. L. REV. 1149 (1976); Englehardt, Rosen, Freedman, & Margolis, *Phenothiazines in the Prevention of Psychiatric Hospitalization*, 16 ARCHIVES GEN. PSYCHIATRY 98 (1967); Hogarty & Goldberg, *Drug and Psychotherapy in the Aftercare of Schizophrenic Patients: One-Year Relapse Rates*, 28 ARCHIVES GEN. PSYCHIATRY 54 (1973); Hogarty, Goldberg, & Schooler, *Drug and Psychotherapy in the Aftercare of Schizophrenic Patients II Two-year Relapse Rates*, 31 ARCHIVES GEN. PSYCHIATRY 603 (1974); Hogarty, Goldberg, & Schooler, *Drug and Psychotherapy in the Aftercare of Schizophrenic Patients III. Adjustment of Non-relapsed Patients*, 31 ARCHIVES GEN. PSYCHIATRY 609 (1974); Klein, Rosen, & Oaks, *Premorbid Asocial Adjustment and Response to Phenothiazine Treatment Among Schizophrenic Inpatients*, 29 ARCHIVES GEN. PSYCHIATRY 480 (1973); Leff & Wing, *Trial of Maintenance Therapy in Schizophrenia*, 3 BRIT. MED. J. 599 (1971); May, *Psychotherapy Research in Schizophrenia—Another View of Present Reality*, 9 SCHIZOPHRENIA BULL. 126 (1974) [hereinafter May, *Psychotherapy Research*]; May, Tuma, & Dixon, *Schizophrenia: A Follow-up Study of the Results of Five Forms of Treatment*, 38 ARCHIVES GEN. PSYCHIATRY 776 (1981) [hereinafter May, *Schizophrenia*]; May, Tuma, Yale, Potepan, & Dixon, *Schizophrenia: A Follow-up Study of Treatment II. Hospital Stay Over Two to Five Years*, 33 ARCHIVES GEN. PSYCHIATRY 481 (1976) [hereinafter May, *Follow-Up*]; May, Van Putten, Yale, Potepan, Jender, Fairchild, Goldstein, & Dixon, *Predicting Individual Responses to Drug Treatment In Schizophrenia: A Test Dose Model*, 162 J. NERVOUS & MENTAL DISEASE 177 (1976) [hereinafter May, *Predicting*]; The National Institute of Mental Health Psychopharmacology Service Center Collaborative Study Group, *Phenothiazine Treatment in Acute Schizophrenia*, 10 ARCHIVES GEN. PSYCHIATRY 246 (1964) [hereinafter Collaborative Study Group]; Williams, Karon, & Vandenbos, *Consequences of Psychotherapy for Schizophrenic Patients*, 9 PSYCHOTHERAPY: THEORY, RES. & PRACT. 111 (1972).

patients—the sort of patient who, when decompensated, would be subject to involuntary commitment in this country.<sup>44</sup> When antipsychotic drugs were discovered in the early 1950's, psychiatry in the United States was predominantly psychoanalytic in orientation and there was considerable inertia to keep it that way. It was not organized psychiatry, but Congress, that mandated research on drug treatment efficacy. As a result of this research, we know the treatment is effective based on objective, scientific evidence. Yet, for many years, even after conclusive evidence was obtained, psychiatric training programs did not cover drug treatment in depth and indeed, a few still do not. Some members of the psychiatric profession remain inadequately trained or uninterested in drug use. A good percentage of them are nontreating physicians. For example, many forensic psychiatrists are not well informed about psychopharmacology and its applications. Psychologists and social workers are generally not trained in psychopharmacology, and they are prohibited by the profession's licensing requirements from prescribing drugs.<sup>45</sup> Not surprisingly, skepticism or opposition to drug use within the mental health professions tends to be confined to those groups. Among physicians who treat mental patients

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44. The class of involuntarily committed psychotic patients is a small subset of mentally ill patients. The physician author of this Article has talked with many leaders of the World Psychiatric Association and the World Health Organization-funded international research centers, and they are in full agreement that psychotropic drug treatment or electroconvulsive therapy is the treatment of choice for these patients. With the exception of a few psychiatrists who work in private sanitaria, there is no dissenting opinion in psychiatry. We do not know of the existence of data which document the treatment of involuntarily committed patients around the world, but our experience in visiting hospitals in numerous countries in both the developed world (Western Europe and Japan) and the developing world (China, India, Thailand, Morocco, Peru, Columbia, Panama) and in talking to the leaders of international psychiatric associations, provides irrefutable support. In short, there is no alternative to drug treatment or ECT for major mental illness, and a ban on either, whether imposed by general law or regulation or at the behest of the patient himself, is a ban on effective treatment. Standard text books from various countries show that there is a world medical standard for the treatment of these psychiatric conditions. See L. HOLLISTER & J. CSERNANSKY, *CLINICAL PHARMACOLOGY OF PSYCHOTHERAPEUTIC DRUGS* (3d ed. 1990); R. KENDALL & A. ZEALLEY, *COMPANION TO PSYCHIATRIC STUDIES* (4th ed. 1988); L. KILOH, J. SMITH, & G. JOHNSON, *PHYSICAL TREATMENTS IN PSYCHIATRY* (1988); J. TUPIN, R. SHADER, & D. HARRETT, *HANDBOOK OF CLINICAL PSYCHOPHARMACOLOGY* (1990).

45. It is worth noting that the American Psychological Association gave the antidrug movement ammunition by filing an amicus brief with the United States Supreme Court in support of the petitioner inmate in *Washington v. Harper*. On the other hand, to give credit when credit is due, it has been the psychologists with methodological expertise who have been principally responsible for the scientific rigor of the controlled studies providing the data on the efficacy of drugs. There has been much recent pressure to allow psychologists to prescribe drugs. This idea is currently being implemented on a limited, experimental basis. It is doubtful that organized psychology will maintain its antidrug stance if and when psychologists are permitted to prescribe the medications.

in hospitals, there is virtually no controversy about either the need for or benefits of drugs.

There is substantial evidence that the major mental disorders are at least in part biologically based.<sup>46</sup> This has strong, if not irresistible, implications for the treatment of these disorders, though the implications have been and continue to be resisted by some. There are both behavioral therapists and psychoanalysts who write about the successes of psychological treatment of patients with major mental illnesses, but a great many of these patients also received psychotropic medication.<sup>47</sup> One cannot make valid inferences about the beneficial results of psychotherapy alone if the data include patients also treated with medication. It has been argued that these studies support the notion that psychotherapy or behavioral therapy given along with drugs produces a better result than drugs alone, but the truth is that drug treatment is a prerequisite for the beneficial effects of psychological treatment. In the psychological treatment cases described, the drugs were an uncontrolled variable of the treatment process, and one can make no inference about what would have happened if they had not been used.<sup>48</sup>

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46. An evaluation of current textbooks in psychiatry indicates that for hospitalized patients, psychiatry as a field is primarily considering biological or biosocial explanations. See, e.g., H. KAPLAN & B. SADOCK, *COMPREHENSIVE TEXTBOOK OF PSYCHIATRY* (5th ed. 1989). Modern psychiatry recognizes both psychosocial and biological antecedents to major mental disorders. It is rare to find a psychiatrist who is exclusively psychological in orientation with respect to committed patients. There is solid, irrefutable evidence that a strong genetic factor is present in their diseases so that those who consider mental illness a myth will have to concede that this "myth" is passed through the genes. It is beyond the scope of this Article to give a review of biological psychiatry, but we know that major mental illnesses have a strong hereditary component. Identical twins usually have the same disease and children (including twins) adopted into normal families have the disease of their biological parents, not their environmental parents. There are many biological abnormalities that have been consistently found in persons suffering from schizophrenia, mania, and psychotic depression.

47. Three of the most frequently quoted studies are: Karon & O'Grady, *Intellectual Test Changes in Schizophrenic Patients in the First Six Months of Treatment*, 6 *PSYCHOTHERAPY: THEORY, RES. & PRAC.* 88 (1969); Karon & Vandebos, *Experience, Medication and the Effectiveness of Psychotherapy with Schizophrenics*, 116 *BRIT. J. PSYCHIATRY* 427 (1970); and Karon & Vandebos, *The Consequences of Psychotherapy for Schizophrenic Patients*, 9 *PSYCHOTHERAPY: THEORY, RES. & PRAC.* 111 (1972). In these studies, many patients in the psychological treatment groups (psychoanalysis or behavior therapy) received drugs. These studies may support the effectiveness of psychological treatment, but they do not negate the effectiveness of drug treatment. Karon combined data from patients who received substantial doses of drugs with those who had only minimal drugs, and many of Paul's "behavior therapy" patients received drugs during the course of the study.

48. Rosen, *The Treatment of Schizophrenic Psychosis by Direct Analytic Therapy*, 21 *PSYCHIATRIC Q.* 117 (1947) (reporting on a series of patients who were said to have dramatic results with psychoanalysis alone). See also J. ROSEN, *DIRECT ANALYSIS* (1953). However, these results were later challenged because many of the patients were not schizophrenic.

Not all drugs used in psychiatry are alike, and they cannot be prescribed indiscriminately for different disorders.<sup>49</sup> Lithium as well as several anticonvulsant drugs may be used effectively in treating acutely manic patients, often in combination with antipsychotic drugs. The former drugs can be used alone, but the rate of response is substantially slower. Severely impaired judgment may persist and, at least potentially, any number of violent acts may take place before the full effect is achieved. For schizophrenia, the only effective drugs are antipsychotics. Electroconvulsive therapy (ECT) also has important uses in the treatment of mania and schizophrenia, especially in emergency cases (e.g., catatonia) or alternatively, when the patient does not respond to the drugs or does not tolerate their side effects. For psychotic depression, effective treatment is ECT or the combination of antipsychotic drugs and antidepressant drugs. Antidepressant drugs alone are not an effective treatment for psychotic depression.<sup>50</sup> There have been no controlled evaluations of psychotherapy alone for the severely manic or the psychotically depressed, involuntarily committed patient. Positive individual case histories of extremely disturbed psychotic patients treated with psychotherapy have been reported, but there are no reports documenting successful treatment without drugs for any large series of patients.<sup>51</sup> It is difficult to believe that large successes occur in either public or private hospitals without the psychotherapists writing about the results.

For patients suffering from schizophrenia who receive psychotherapy alone, the results have been disastrous.<sup>52</sup> There have been a few control studies and all of them report that psychotherapy by itself does not

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Horwitz, Polantin, Kolb, & Hoch, *A Study of Cases of Schizophrenia Treated by "Direct Analysis,"* 114 AM. J. PSYCHIATRY 780 (1958). In addition, a substantial number of patients were rehospitalized at the time the author was claiming permanent cures. This follow-up by an independent psychiatrist destroyed the credibility of the original report. The claims for psychotherapy alone simply have not held up.

49. Important as this information is, it is lost in the legal context when right-to-refuse treatment decisions fail to differentiate among illnesses or drugs and psychotherapy is indiscriminately viewed as an alternative.

50. The treatment for schizophrenia, mania, and psychotic depression is similar worldwide. Like physics or chemistry, psychopharmacology is universal. Some standard U.S. textbooks are translated and used in developing countries, such as the physician author's textbook on psychopharmacology which has been translated in Chinese and used in the Peoples Republic of China. See W. APPLETON & J. DAVIS, PRACTICAL CLINICAL PSYCHOPHARMACOLOGY (2d ed. 1980). English has become an international medical language, and the texts are read by academic psychiatrists in English. Academics who write their own text in their native language draw upon the same sources of psychopharmacologic knowledge quoted here and summarized above.

51. See *supra* note 43.

52. The physician author has reviewed the data in detail elsewhere. See M. GREENBLATT, *supra* note 43; L. GRINSPOON, *supra* note 43; Davis, & Chang, *supra* note 43.

produce good results and is inferior to drug therapy.<sup>53</sup> When psychotherapy is used in addition to drug therapy in an inpatient setting, the outcome (as measured by the discharge rate) is not materially affected.<sup>54</sup> Some studies find a somewhat better outcome and others find little or no difference.<sup>55</sup> After patients are discharged from the hospital and are living at home, and when supportive family treatment is added to antipsychotic drugs, the combined therapies are substantially better than drug therapy alone. The key in post-discharge situations is to educate the patient about the nature of the schizophrenic illness and to help the patient and the family adapt to the illness.<sup>56</sup> For the hospitalized population, however, control studies demonstrate conclusively that drug-free patients fare poorly and that psychotherapy alone is useless.<sup>57</sup>

With appropriate drug treatment, the vast majority of hospitalized patients improve to the point where they can return home rather quickly.<sup>58</sup>

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53. See M. GREENBLATT, *supra* note 43.

54. See May & Simpson, *Schizophrenia: Evaluation of Treatment Methods*, in COMPREHENSIVE TEXTBOOK OF PSYCHIATRY 1240-74 (H. Kaplan, A. Freedman, B. Sadock eds. 3rd ed. 1980); Schooler, *Antipsychotic Drugs and Psychological Treatment in Schizophrenia* in PSYCHOPHARMACOLOGY: A GENERATION OF PROGRESS 1155-68 (M. Lipton, A. DiMascio, & K. Killam eds. 1978).

55. The best of these studies are from the McLean Hospital at Harvard University. See Gunderson, Frank, Katz, Vannicelli, Frosch, & Knapp, *Effects of Psychotherapy on Schizophrenia II. Comparative Outcome of Two Forms of Treatment*, 10 SCHIZOPHRENIA BULL. 564 (1984) (finding some gains, but not substantial gains, when psychotherapy was added to drugs). One can argue about how great an advantage psychotherapy is, but we emphasize that this is psychotherapy-plus-drugs. Such data are not relevant to the right to refuse medication treatment.

56. There are several controlled studies supporting the efficacy of psychotherapy-plus-drugs. Psychotherapy in the outpatient setting has been proven to be effective, but we must emphasize again that it is given with drugs. Indeed the family effect found in these studies is equal to the drug effects in magnitude. As a practical matter, however, such intensive family therapy is generally not available except in a research setting at a few institutions, but its use is spreading. We enthusiastically recommend such psychotherapy and our above remarks against psychotherapy alone are to be placed in the context of our argument on the right to refuse drug treatment. We are not against psychotherapy.

57. See May & Tuma, *Community Follow-up of Treatment of Schizophrenia Issues and Problems*, 35 AM. J. ORTHOPSYCHIATRY 754 (1965); May & Tuma, *Treatment of Schizophrenia*, 3 BRIT. J. PSYCHIATRY 503 (1965).

58. Exact data pertinent to our context are difficult to find. For the specific purposes of this Article, we checked with physicians at random in both private hospitals and in the public sector state hospital system. Respondents in both settings indicated that it is rare for a patient to be hospitalized continuously for more than "a few weeks." Some private hospitals have long-term care sections, but even there, the length of stay is counted in months, not years. The 1980 National Data Book produced by the United States Department of Health and Human Services pegged the average length of stay for patients in public mental health facilities, undifferentiated by type of admission, at slightly longer than three weeks. More recent estimates speak of even shorter terms. By contrast, a 1990 publication uses 1983 NIMH

The time for improvement is important.<sup>59</sup> It takes about three to four weeks to achieve substantial improvement and approximately six weeks more to get optimal improvement. The majority of patients usually recover enough to be discharged in the first several weeks, but drug-induced improvement continues when the medication is taken at home. Some patients will have residual symptoms, but many will be "cured" or almost cured. The more accurate term which physicians use is "in remission," because many of these patients will relapse in the ensuing years. Some will never function well outside a hospital despite the improvement they showed in the hospital.

What is important for patients' rights is that, with medication, most patients recover enough to go home and have their liberty restored. Once free and competent (if we may use the word in its common sense meaning), they can then choose to refuse or to take medication. Paradoxically, if their right to refuse medication is protected as an absolute right, they will never make the decision in a "competent" state themselves. The legal process will make it for them.

It should also be noted that for patients suffering from one of the major mental illnesses, there is no alternate "less restrictive" treatment to drugs or ECT. The alternative is no treatment.<sup>60</sup> Some may say that drug treatment makes psychological treatment possible and is not in itself primary. Even if this were true, it would not affect our argument. The prominent antidrug psychiatrist Laing referred his very ill patients for

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"utilization" survey data to arrive at substantially longer hospitalization terms. See Rosenheck & Astrachan, *Regional Variation in Patterns of Inpatient Psychiatric Care*, 147 AM. J. PSYCHIATRY 1180 (1990). Combining figures from all components of the inpatient mental health care system (general and psychiatric, private and public, federal as well as state and county), this study reports the average length of stay as 41 days; 92 days for patients in state and county mental facilities. To the extent the discrepancies are explainable at all, they may be traced to the fact that a small percentage of chronic, long-term patients drives up the average dramatically. The lower official reports and estimates for the average patient may remain accurate.

59. Patients who refuse medication also increase the length of hospitalization—their own as well as the general average.

60. We have noted above, both in the text and footnotes, that for involuntarily committed patients suffering from the major mental illnesses (schizophrenia, mania, psychotic depression), the world-wide standard treatment is psychotropic drugs or ECT, the former being in legal nomenclature a less restrictive alternative. We cannot find reference to less restrictive alternatives when patients with these diagnoses and this level of severity are managed without medication or ECT. Neither are less restrictive alternatives advocated in standard psychiatric textbooks in any country of this world or in reports published by official bodies such as the FDA, the American Medical Association, or the American Psychiatric Association. See, e.g., M. GREENBLATT, *supra* note 43; Davis, Janicak, Chang, & Klerman, *Recent Advances in Pharmacologic Treatment of the Schizophrenia Disorders*, PSYCHIATRY 1982 ANNUAL REVIEW 178 (1982). Psychiatric textbooks have chapters on a wide variety of psychosocial treatments, but these texts also recommend medication.

pharmacotherapy.<sup>61</sup> It is extremely rare to find a psychiatrist who does not either prescribe or refer some of his patients to others for medications. We have no hard data, but we estimate that 99 out of 100 psychiatrists use medication in at least some of their cases. Intensive, long-term inpatient psychoanalysis is not even offered in most hospitals. Drugs are equally used in expensive private or academic hospitals and in state hospitals. It is not true that wealthy patients with major mental illnesses receive psychotherapy without drugs and that poor patients are drugged.<sup>62</sup>

### C. Clinical Benefits of Drug Treatment

We now turn to the "hard" data from controlled studies to show the benefits of antipsychotic drug treatment. As an example, we use the raw data from an early National Institute of Mental Health (NIMH) study comparing the efficacy of drugs (*i.e.*, chlorpromazine, thioridazine, and fluphenazine) against a placebo for schizophrenic patients.<sup>63</sup> The results were dramatic and today they would be even stronger, given the development of more effective drugs and a more sophisticated knowledge of when and how to use them.

In this study, some 350 patients were randomly assigned to receive the medications, which were then new, or the placebo. The trials, which ran for six weeks, were double blind in that neither the patient nor the physician knew which subjects were receiving the medication or the placebo, both of which were administered in identical capsules or tablets. The clinical changes were evaluated by unbiased blind raters using quantitative evaluation scales.

The outcome was reflected by two variables: one measured improvement over the course of the trial, and the other assessed the patient's

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61. The physician author has personally discussed this question with Dr. Laing, who told the author that he referred the more disturbed patients to a biological psychiatrist as an addition to psychotherapy. Many of the "nonmedical" psychotherapists deal with outpatients who are selected to be good candidates for psychotherapy. These are substantially different patients than involuntarily committed patients. Even for such different populations, Laing and his coworkers explicitly state that the *majority* of patients also receive drugs. See Esterson, Cooper, & Laing, *Results of Family-Oriented Therapy with Hospitalized Schizophrenics*, 2 BRIT. MED. J. 1462 (1965).

62. There is a social movement of followers of Thomas Szasz and Peter Breggin, most of whom are nonmedical and whose "thesis" is rejected by the medical community. This movement is against all coercive psychiatry and posits the proposition that mental illness is a myth. The leaders of this movement, who themselves are practicing psychiatrists, know better, but their followers do not. The same phenomenon can be found in medicine and surgery. Christian Science, for example, rejects virtually all of contemporary medicine. There are advocates for laetrile and other miracle interventions. These are fringe positions or ideologies not to be confused with legitimately debatable schools of scientific or professional thought.

63. Cole, *Drugs*, *supra* note 43; Collaborative Study Group, *supra* note 43.

condition at the end. At the beginning of the study, most patients had severe psychotic symptoms and almost all were rated as either moderately ill or severely ill. The study hypothesized that at the end of six weeks, patients could be completely remitted, have only borderline symptoms, or retain more noticeable symptoms ranging from mild to moderate to severe. The progressive improvement scale used the ratings very much improved, substantially improved, improved, no change, or worse.

Changes During Trial	Condition After Trial	% of Patients on Drug	% of Patients on Placebo
Very much improved	Remitted	16	1
Substantially improved	Borderline symptoms	29	11
Improved	Mild symptoms remain	16	10
Improved	Moderately ill	31	31
Not changed	Moderately ill	6	15
Deteriorated	Severely ill	2	33

Note that at virtually every point on the scale patients receiving drugs did significantly better than those receiving the placebo. Forty-five percent (16% + 29%) of the drug patients were rated as very much or substantially improved, with either complete disappearance of symptoms or only a few minor symptoms remaining. Only twelve percent (1% + 11%) of the placebo patients showed comparable improvement. The great majority of placebo patients (31% + 15% + 33%) were rated as still having at least a moderate degree of schizophrenic illness, with one-third (the last category) showing marked deterioration to severe illness. Failure to treat in the first six weeks thus leads to serious clinical harm for many patients.

We have presented an original study to give the lawyer a feel for the raw data. This was a National Institute of Mental Health study performed by academic investigators from a university. It is consistent with approximately seventy other placebo-controlled studies.<sup>64</sup> There are

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64. D. KLEIN & J. DAVIS, *supra* note 43; Davis, *Recent Developments in the Drug Treatment of Schizophrenia*, 133 AM. J. PSYCHIATRY 208 (1976); Davis, Janicak, Chang, & Klerman, *supra* note 43; Davis, Janicak, Linden, Moloneoy, & Pavkovic, *Neuroleptics and Psychotic Disorders*, in *NEUROLEPTICS: NEUROCHEMICAL, BEHAVIORIAL AND CLINICAL PERSPECTIVES* (J. Coyle & S. Enna eds. 1983). Many of the legal critics of drug treatment cite standard psychiatric texts such as the author's book as reference for side effects, but do not mention the evidence for its efficacy. See, e.g., W. APPLETON & J. DAVIS, *supra* note 50; DuBose, *supra* note 43.

no contradictory data. Furthermore, dose-response studies confirm that there is a positive correlation between the amount of drug given and the beneficial effects.<sup>65</sup>

Much of the legal literature refers to the principle of least restrictive treatment, as if there are effective treatments of major mental illness other than drug treatment and ECT. Many legal commentators assume that drugs are ineffective as treatment and are effective only as sedatives or as a form of punishment.<sup>66</sup> The sedative property makes the institution safer by tranquilizing the violent patients, and the punishment effect deters violence. This is false. Most antipsychotic drugs have minimal sedative properties, some have mild to moderate sedative effects, and a few are not sedative at all.<sup>67</sup> In addition, there is no evidence showing that they are effective negative reinforcers in animals or that their benefit in humans is due to punishment.

#### *D. Research Findings on the Harms Resulting from Delayed Treatment*

A patient's exercise of the right to refuse treatment means that there will be no treatment or, at least, that it will be delayed. The difference may not be material because there is substantial evidence that treatment delayed is treatment denied. The legal rights community is unaware or ignores the exorbitant costs of delayed or denied treatment. Substantial clinical harms can result to patients who are not treated in a timely fashion. In turn, clinically deteriorating patients can do much harm to their institutional surroundings and simultaneously increase the financial costs of their own care as well as the care of their fellow patients. These costs will in many cases be charged to the public health systems (*i.e.*, they will be "societal" in a direct sense as well as in subtler, more circuitous ways through insurance rates or other welfare taxes). Finally, time itself can be viewed as a cost when nothing of clinical or legal benefit is accomplished as a result of ill-advised assertions of the right to refuse treatment.

*1. Time Costs of Refusals: Loss Without Gain.*—When the law states that a patient's refusal can be overridden only by judicial process, critical treatment time is lost. Most patients wait for many weeks or even months with no effective treatment. There is then a judicial hearing in a so-called medication court, and almost always, the judge orders treatment. Thus,

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65. See Davis, Barter, & Kane, *Antipsychotic Drugs*, in H. KAPLAN & B. SADOCK, *COMPREHENSIVE TEXTBOOK OF PSYCHIATRY* 1662 (5th ed. 1989).

66. See *supra* notes 31-32.

67. See Davis, Barter, & Kane, *supra* note 65, at 1662.

nothing is gained in the legal sense, but much may be lost in terms of the patient's clinical condition.

Massachusetts is one state which has had substantial experience with judicial review of medication, first under the temporary restraining order (TRO) issued in the *Rogers v. Okin*<sup>68</sup> case and again when the Massachusetts Supreme Court affirmed *Rogers* on remand.<sup>69</sup> Under the *Rogers* mandate, medication, except in strict emergency situations, cannot be administered over a patient's objection, unless the patient is first ruled incompetent by a court. Several studies examined the time from the patient's first refusal to the judicial decision. These studies found that these cases took an average of four and a half months to come to trial.<sup>70</sup> Moreover, the outcomes of these cases suggest that almost all refusals lacked reasonable bases. In one study of 1,514 Massachusetts cases, courts ultimately overrode the patient in all but twenty-one (3.4%) of the cases.<sup>71</sup>

A much smaller study at the Central New York Psychiatric Center, a treatment facility for convicted offenders and pretrial detainees, focused on the effects of *Rivers v. Katz*.<sup>72</sup> This case, like *Rogers*, requires a judicial competency hearing to override a patient's refusal of treatment.<sup>73</sup> Of eighteen refusers, three complied with the medical recommendation prior to the hearing. In each of the remaining fifteen cases, the court found the patient incompetent and approved the proposed medication. The average time between the doctors' override petition to the court and the hearing was twenty-four days.

Though generally less time-consuming than the judicial process, a variety of clinical review procedures imposed by the courts have also proved more costly than beneficial to the patients they were intended to protect. A 1983 study at the forensic unit of Oregon State Hospital

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68. 478 F. Supp. 1342 (D. Mass. 1979), *aff'd in part, rev'd in part*, 634 F.2d 650 (1st Cir. 1980), *vacated sub nom.* Mills v. Rogers, 457 U.S. 291 (1982).

69. *Rogers v. Commissioner of Dep't of Mental Health*, 390 Mass. 489, 458 N.E.2d 308 (1983).

70. See Hoge, Gutheil, & Kaplan, *The Right to Refuse Treatment under Rogers v. Commissioner: Preliminary Empirical Findings and Comparisons*, 15 BULL. AM. ACAD. PSYCHIATRY & L. 163 (1987) [hereinafter Hoge, *Right to Refuse*]; Veliz & James, *Medicine Court: Rogers in Practice*, 144 AM. J. PSYCHIATRY 62 (1987).

71. Schouten & Gutheil, *Aftermath of the Rogers Decision: Assessing the Costs*, 147 AM. J. PSYCHIATRY 1348 (1990). Earlier, we noted the finding that almost all involuntary patients refuse treatment for delusional reasons. See *infra* text accompanying note 115. Another empirical finding is that the courts, although ostensibly deciding the issue of the patient's competency, in fact focus on the appropriateness of the prescribed treatment. See Applebaum, *The Right to Refuse Treatment with Antipsychotic Medications: Retrospect and Prospects*, 145 AM. J. PSYCHIATRY 413, 416 (1988).

72. 67 N.Y.2d 485, 495 N.E.2d 337, 504 N.Y.S.2d 74 (1986).

73. Deland & Borenstein, *Medicine Court II: Rivers in Practice*, 147 AM. J. PSYCHIATRY 38 (1990).

reported on thirty-three insanity acquittee patients who refused medication.<sup>74</sup> The independent psychiatrists performing the initial clinical review recommended treatment overrides in all cases. The chief medical officer, with final authority in the disputes, agreed in thirty-two cases. The process took an average of nine days. During the nine days between the refusal and override decision, there were thirty-six psychiatric emergencies for the thirty-three unmedicated patients.

In another study, several of the same researchers focused on treatment refusals in one of Oregon's civil hospitals, including patients who objected to treatment upon admission, as well as those who complied initially but refused later.<sup>75</sup> The rate of override, by the same clinical review process as in the forensic setting, was ninety-five percent for all cases, with the length of time between the override petition and the decision being fifteen days on the average for the initial refusers and a full seventy-seven days for patients who were compliant, but later became uncooperative.

Under the *Jamison-Farabee*<sup>76</sup> consent decree in California, which mandated outside clinical review of all treatment plans involving psychoactive medications within three days, 2,700 cases received this second medical opinion over a period of three years.<sup>77</sup> The results were approval of medication in over ninety-eight percent of the cases and reversals in less than two percent. In these forty-seven instances, significant deterioration occurred in twenty-five, no deterioration was seen in eight, and the clinical outcome of the rest was unclear.<sup>78</sup> Although the California procedure results in minimal delay, it wastes clinical resources in performing the review and results in harm to many of the patients whose refusal of treatment is not overridden.

A 1982 study reported on a former clinical treatment review protocol at Minnesota's Anoka State Hospital, a 236-bed facility serving the Minneapolis-St. Paul metropolitan area.<sup>79</sup> Treatment refusals (classified as

74. Williams, Bloom, Faulkner, Rogers, & Godard, *Drug Treatment Refusal and Length of Hospitalization of Insanity Acquittees*, 16 BULL. AM. ACAD. PSYCHIATRY & L. 279 (1988). In the one remaining case, the patient deteriorated one month later, and a second examiner recommended treatment. Thus, the treatment overrides were sustained in 97% of the cases initially and 100% if the subsequent second opinion is counted. Oregon uses an administrative review mechanism developed originally in New Jersey. It responds to an existing statute specifying that involuntary patients have a right to be free from "unusual or hazardous treatment procedures including ECT unless they have given their express and informed consent."

75. Bloom, *An Empirical View*, *supra* note 41.

76. No. 78-0445 WHO, slip op. (N.D. Cal. Apr. 26, 1983).

77. See Hargraves, Shumway, Knutsen, Weinstein, & Swuter, *Effects of the Jamison-Farabee Consent Decree: Due Process Protection for Involuntary Psychiatric Patients Treated with Psychoactive Drugs*, 144 AM. J. PSYCHIATRY 188, 190 (1987).

78. *Id.*

79. Zito, Lentz, Routt, & Olson, *The Treatment Review Panel: A Solution to Treatment Refusal?*, 12 BULL. AM. ACAD. PSYCHIATRY & L. 349 (1984).

emergency or nonemergency) were reviewed by a treatment review panel (TRP), which approved administration of the medication in ninety-five percent (59/62) of the emergency cases and sixty-seven percent (127/191) of the nonemergencies during the twenty month study period. Under the protocol, the TRP's decision was required to be made within seven days. The rate of refusals was fifteen percent among admissions during this period, with a sizable number of patients refusing repeatedly, leading to multiple reviews of their cases.<sup>80</sup>

In total, there have been approximately twelve studies of 5,000 cases of patient's refusals of treatment.<sup>81</sup> Courts have sustained the refusal in only three percent of the cases, at an average time cost of forty-eight days. Clinical review has affirmed the patient's rejection of treatment in four percent of the cases<sup>82</sup> and comes at a cost of three to fifteen days in treatment time lost (not counting the unusual seventy-seven day delay for post-admission refusers in Oregon's civil hospital). Several reports note that even in those rare cases when the formal judicial or clinical decision upholds the patient's right to refuse, clinical deterioration often results.<sup>83</sup> Finally, not one of the studies reports clinical benefit to the patient from a delay in treatment. Most studies did not specifically look for such results, but presumably would have noted them if found incidentally. The lack of such a finding is more significant yet for those that did.<sup>84</sup>

2. *Clinical Costs: Long-Term Harms.*—Because reviews of patients' refusals take substantial time, it is important to ascertain whether and to what extent long-term treatment delay affects recovery. Although most controlled trials last only weeks, one longitudinal study of the effect of psychotherapy versus drug therapy by May and his co-workers is particularly relevant.<sup>85</sup> Patients were randomly assigned to receive either med-

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80. The incidence of refusals varies greatly from institution to institution, ranging from one to twenty-five percent. Much depends on the type and timing of the review mandated because many patients refuse to cooperate initially, but then relent as they achieve a level of comfort and stability within the institution. A patient does not become an official refuser until the review machinery is activated. See Bloom, *An Empirical View*, *supra* note 41; Hoge, Appelbaum, Lawlor, Beck, Litman, Greer, Crutheil, & Kaplan, *A Prospective, Multicenter Study of Patients' Refusal of Antipsychotic Medication*, 47 ARCH. GEN. PSYCHIATRY 949 (1990); Hoge, *Right to Refuse*, *supra* note 70; Veliz & James, *supra* note 70.

81. See *supra* notes 70-80.

82. The results stemming from the studies of the *Jamison* decree and *Rogers v. Okin* still the override averages because of the large number of cases. If, in order to correct for this, the mean number is used, the proportion of cases in which the patient's refusal is upheld is still under 10%.

83. See, e.g., Veliz & James, *supra* note 70, at 64.

84. See Ciccone, *Right to Refuse*, *supra* note 41.

85. P. MAY, *supra* note 43; May, *Psychotherapy Research*, *supra* note 43; May, *Follow-up*, *supra* note 43; May, *Predicting*, *supra* note 43; May, *Schizophrenia*, *supra* note 43.

ication or no medication. After six months, the group which did not receive medication was then given medication. May found that those patients who did not initially receive drugs for the six month period did substantially worse during the following three to five years, spending almost twice as much time in the hospital as did the initially medicated patients.

The study documents the harmful consequences that may occur when patients do not receive initial medication and treatment is delayed for a substantial span of time. Not only do patients do much worse during the initial phase of treatment when they are not receiving drugs, but even after drugs are taken, there is a long-term negative carryover effect. Although the judicial review process falls well short of six months, it can nevertheless be quite lengthy (e.g., four-plus months in the Massachusetts study), and it is quite possible that such protracted treatment delays produce negative long-term consequences. The data collected by May suggest that once deterioration occurs, it may be irreversible. May's results are reliable. Patients were randomly assigned to the different samples so the groups were strictly comparable. Evaluations of outcome were done "blind" and are thus objective and unbiased.

3. *Institutional Costs and Harms.*—As well as doing harm to individuals, prohibition or delay of treatment also has undesirable consequences for institutions. In an early review of the actual and potential effects of the right to refuse treatment, Stone considered the experience at Boston State Hospital, which, at the time, was under a temporary federal district court order prohibiting physicians from forcibly medicating patients except in extreme emergencies.<sup>86</sup> He quoted from the Massachusetts Psychiatric Society's amicus brief in this initial phase of the *Rogers v. Okin* litigation:

One wing has been destroyed by fire, set by a patient. One female patient attempted to burn a staff member, to choke a patient, and to strangle herself with a ripped dress. . . . A schizophrenic male patient who has refused medication since the grant of the temporary restraining order has had sexual intercourse with at least three different patients who are either retarded or are severely and chronically regressed . . . [and has] grabbed and threatened two female staff members.<sup>87</sup>

A later article on the same phase of the Boston hospital case provided additional information regarding the two wards most directly affected by

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86. Stone, *Recent Mental Health Litigation: A Critical Perspective*, 134 AM. J. PSYCHIATRY 273 (1977) (discussing the implicit analogies the legal system has made between psychiatrists and agents of the criminal justice system and their effects on mental health care).

87. *Id.* at 278.

the *Rogers* TRO, which by then had been transformed into a permanent injunction.<sup>88</sup> Hospital witnesses specifically identified 145 patients who had suffered adverse consequences from their decision to refuse medication treatment during the two-plus year period from May 1975 to August 1977: eighty-nine whose mental condition deteriorated and fifty-six whose hospitalization had to be prolonged. The time spans during which patients had to remain untreated were long, ranging from two to as much as eleven months. The number of patients transferred to other hospitals because they were too disturbed to be cared for at Boston State went up by 370%. In addition, patients known to be likely to refuse treatment were denied admission. Despite the transfers and denials of admission, the rate of seclusion was up dramatically—in some months up to three times the monthly rates prior to the order.<sup>89</sup> The level of violence also increased markedly. One patient with no history of violence deteriorated to such an extent that he attacked an attendant, fracturing one of the latter's facial bones, which required surgery. He later attacked another attendant, injuring the man's cervical spine. This attendant did not return to work. The patient suffered from severe guilt from these actions. Staff turnover doubled as residents quit their jobs in unprecedented numbers.

Another report on the Boston State Hospital situation noted that among patients refusing treatment, many deteriorated to a point where they became assaultive or self-destructive.<sup>90</sup> Nevertheless, physicians attempting to force treatment on a psychotic young woman for physical deterioration when she refused food on pseudo-religious grounds were found in contempt of court.<sup>91</sup> Of the fourteen patients who were denied admission during this period because of indications they would not co-operate with treatment, one subsequently stole a truck and was shot to death by police pursuing him. Yet another article attributes a suicide to the refusal to be treated:

[T]he one suicide in our series of patients who refused medication occurred in a paranoid man from a high achieving family. . . . He spent an unconscionably long time in a severe and florid

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88. See Schultz, *The Boston State Hospital Case: A Conflict of Civil Liberties and True Liberalism*, 139 AM. J. PSYCHIATRY 183 (1982).

89. Another study conducted at the Mendota Forensic Center, a maximum security facility in Madison, Wisconsin, reported a six-fold jump in the total number of seclusion hours following the introduction of a right-to-refuse protocol. Miller, Bernstein, Van Rybroek, & Maier, *The Impact of the Right to Refuse Treatment in a Forensic Patient Population: Six-Month Review*, 17 BULL. AM. ACAD. PSYCHIATRY & L. 107 (1989).

90. Gill, *Side Effects of a Right to Refuse Treatment Lawsuit: The Boston State Hospital Experience*, in REFUSING TREATMENT IN MENTAL HEALTH INSTITUTIONS—VALUES IN CONFLICT 81-87 (A. Doudera & J. Swazey eds. 1982).

91. *Id.* at 86.

regression because of delays in judicial and departmental procedures in obtaining guardianship. The clinicians involved believed that this prolonged the state of being . . . "really crazy," and . . . played a role in the patient's suicide.<sup>92</sup>

Gutheil and Mills noted that when clinical and legal representatives met to redesign the Massachusetts Department of Mental Health's regulations on involuntary medication following *Rogers*, the lawyers insisted that each incident of violence and the attempt to control it constituted an independent legal event.<sup>93</sup> This "one-punch-one-shot" approach to treatment means that a violent patient must assault someone before he can be given an injection. The concept of continually monitored treatment and control via medications responsive to the patient's specific (and variable) condition was entirely foreign to these "patients' advocates."

The report by Bloom on refusals of treatment in Oregon's civil hospital recorded 147 episodes of seclusion and thirty-two instances of emergency medication for the twelve patients who refused treatment after admission.<sup>94</sup> The high numbers of seclusions and emergency medications are in part because patients were untreated for an average time span of seventy-seven days (while the override decision was being processed), but they remain disturbing.

There is now empirical evidence on what happens to patients when they do not receive proper medication in a timely fashion. The legal profession should take this evidence into account. Lawyers who advocate for the right to refuse treatment must recognize the real potential for psychosis-related harm to individual patients: suicide, accidental death, or other harm to the patient resulting from psychotic activity that could have been prevented. The patient was committed because of the danger to himself and others. Without treatment, this risk continues and even escalates. The psychiatric hospital can prevent some instances of self-harm, but not all. It is difficult to prevent suicide by a determined individual. Psychotic self-harm, due to the wide variety of bizarre ideas patients can have, is unpredictable. The same is true of harm to others. Even a well-run hospital can only reduce the chance that a patient attacks another patient or a staff member. The hospital cannot always prevent such attacks, and in attempting to reduce the threat to others, the treatment and liberty interests of all patients suffer. It is an empirical fact that without med-

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92. Applebaum & Gutheil, *The Boston State Hospital Case: "Involuntary Mind Control," the Constitution, and the "Right to Rot,"* 137 AM. J. PSYCHIATRY 720, 723 (1980).

93. Gutheil & Mills, *Legal Conceptualizations, Legal Fictions, and the Manipulation of Reality: Conflict Between Models of Decision Making in Psychiatry and Law*, 10 BULL. AM. ACAD. PSYCHIATRY & L. 17, 19 (1982).

94. See Bloom, *An Empirical View*, *supra* note 41, at 323.

ication, the incidence of serious harm due to patients' violence goes up significantly. This might have been predicted from the observation that the incidence of violence decreased markedly when antipsychotic drugs first were used.<sup>95</sup>

4. *Financial Costs.*—The financial cost implications of the right to refuse treatment are substantial. Hospitalization fees range from \$100 to \$800 per day. Assuming a hospital cost of about \$400 per day and four and one-half months of hospitalization, the cost is \$50,000. For a state hospital, the legislature sets the budget, and if the cost of caring for certain patients is significantly increased, the quality of care to other patients proportionately decreases. For insured patients, the cost is passed on to the insurance carrier and hence, is eventually borne by all those paying premiums. Additionally, the costs of the legal proceedings should be considered, though these are small on a per case basis compared to the cost of the unnecessary hospitalization. For a medication refuser, the cost of hospitalization will be many times the cost of treating the acute episode.

Perr did a cost-accounting for two private hospital patients who refused treatment.<sup>96</sup> One had to wait three weeks, the other more than two months, for the first judicial hearing. Excluding the court costs, the price of the patient's refusals in extra institutional care and legal fees was \$13,000 for the first and \$19,000 for the second patient.<sup>97</sup> None of this, of course, takes into account the "hidden" costs of managing a deteriorating patient and the attendant effects on the safety and quality of care within the institution generally.

In the aggregate, the financial costs of the review proceedings themselves are substantial. The judicial process is by far the more expensive of the two. One study estimated that the *Rogers* hearings in Massachusetts

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95. Schultz reports that the seclusion rate at Boston State Hospital dropped by 90% in 1955 following the introduction of psychotropic medications. Schultz, *supra* note 88, at 185. The law allows the forcible use of psychotropic drugs in emergencies, but defines emergency strictly. In many institutions, medication can be given only after a serious assault has occurred. Antipsychotics require time to become effective. The rate of symptom improvement is about 50% in the first 10 days, but symptoms persist even at six weeks, and improvement usually continues during this time and for several weeks beyond. Psychiatrists cannot predict the exact minute that a violent action will take place. Even if they could, medications do not have the desired effect in time. More to the point, if psychiatrists could predict the exact minute a violent attack will take place, they would place the patient in seclusion or a restraint, rather than medicate him.

96. See Perr, *Effect of the Rennie Decision on Private Hospitalization in New Jersey: Two Case Reports*, 138 AM. J. PSYCHIATRY 774 (1981) [hereinafter Perr, *Rennie Decision*]. For further discussion, see Perr, *The Rennie Philosophy and Treatment in the Private Sector*, in REFUSING TREATMENT IN MENTAL HEALTH INSTITUTIONS—VALUES IN CONFLICT 81-87 (A. Doudera & J. Swazey, eds. 1982).

97. Perr, *Rennie Decision*, *supra* note 96, at 776-77.

cost the state upwards of one million dollars per year in payments to judges, lawyers, and medical witnesses—a figure supported by the fact that the Massachusetts legislature in 1986 designated a supplemental appropriation of \$826,000 for this purpose.<sup>98</sup> Clinical review procedures, though less costly, also take “real money.” The *Jamison-Farabee* automatic review procedures have been estimated to have cost the state of California \$300,000 per year during their implementation at Napa State Hospital.<sup>99</sup> Had the model been imposed on all of the state’s facilities, the costs would have been in excess of one million dollars. The Anoka State Hospital TRP procedures (depicted as less formal than the California clinical review) are estimated to have cost the state of Minnesota \$30,000 annually.<sup>100</sup> Contributing to the relative modesty of this sum is the fact that Anoka State is a relatively small (236-bed) facility.

#### *E. The True Risk of Side Effects*

Legal decisions and law review articles are filled with long lists of the side effects of antipsychotic drugs, as if all patients had all side effects to the most severe degree. It is difficult to detect or gauge the side effects of these drugs in the first weeks or months of treatment, but they are rarely serious or permanent. Almost all patients will experience mild side effects such as dry mouth or mild tremor. These effects are transitory and disappear completely when the medication is discontinued. On the average, the initial side effects of antipsychotic drugs are no worse than those of the medications patients receive for serious physical diseases. It is difficult to quantify discomfort, but the general medical judgment is that the side effects of antipsychotic drugs are on the level of those resulting from hypertension medication and are certainly far less severe than those attendant to the use of such medications as anticancer drugs or those administered in conjunction with transplant surgery.<sup>101</sup>

There is a risk in everything we do in life, but it is a scare tactic to suggest that because a serious event can occur, it is a typical outcome. For example, one of the most dangerous things almost all of us do is to drive or ride in an automobile. One can be killed or seriously injured in an automobile accident, yet that does not mean that every time we drive to work there is a high probability that we will be killed or seriously injured.

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98. Hoge, *Right to Refuse*, *supra*, note 70, at 168.

99. *Id.* at 186.

100. *Id.*

101. Virtually all patients receiving psychotropic drugs will experience some side effects, but most are mild. Even for the stronger reactions, it is important to put them in a general medical perspective.

The right-to-refuse treatment movement has claimed that antipsychotic drugs cause cancer and heart attacks. They do not cause cancer, and it is distressing to note that even judicial opinions have repeated this wholly unfounded charge and thereby given it credibility.<sup>102</sup> A controversy in the medical literature exists as to whether antipsychotic drugs are associated with sudden death (presumably due to heart failure). Every year, some 600,000 persons in the United States die suddenly; therefore, everyone is at risk for sudden death. The American Psychiatric Association has reviewed the case histories of patients on psychotropic drugs who have died suddenly and has concluded that this is probably coincidence. Currently, there is no evidence from epidemiologic studies that psychotropic drugs cause sudden death. Indeed, what evidence there is suggests that they do not.<sup>103</sup>

There is no doubt that the dystonic reactions (a type of muscle spasm) that some patients experience are alarming and painful, but it would be extremely unusual for them to be medically dangerous,<sup>104</sup> and they can be effectively treated with antiparkinsonian medication. Another side effect is akathesia, which is a feeling of motor restlessness. In some cases it is just a mild sensation, but it may be moderate or pronounced. Nevertheless, to suggest that severe cases are typical and will invariably occur is pure demagoguery. There are now a number of medications which quickly and effectively treat dystonia and akathesia.<sup>105</sup> Moreover, both dystonic reactions and akathesia will simply go away when the drug is stopped.

Patients can also have a side effect known as neuroleptic malignant syndrome which is characterized by a sudden steep elevation in temperature

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102. See *Davis v. Hubbard*, 506 F. Supp. 915, 928 (N.D. Ohio 1980); *Rennie v. Klein*, 476 F. Supp. 1294, 1298 (D.N.J. 1978), *modified*, 653 F.2d 836 (3rd Cir. 1987), *vacated*, 458 U.S. 1119 (1982).

103. The FDA states that sudden death occurs, but that no causal association has been established. The American Psychiatric Association Task Force on the matter reached a similar conclusion. See G. SIMPSON, J. DAVIS, J. JEFFERSON, & J. PEREZ-CRUET, SUDDEN DEATH IN PSYCHIATRIC PATIENTS: THE ROLE OF NEUROLEPTIC DRUGS (1988).

104. We do not argue that side effects such as dystonia and akathesia are trivial. Indeed, the physician author of this Article has done research on these reactions because it is important for psychiatrists to understand their mechanics and to develop better preventive and treatment methods. It is a scare tactic to suggest, however, that these reactions are medically dangerous. The legal literature is filled with dishonest assertions. In addition to overstating the seriousness and incidence of certain side effects, it also lists conditions that simply have no causal relation to antipsychotics whatsoever (e.g., cancer) or others where the cause and effect are unknown (e.g., sudden death). In their treatment of TD, the legal writings succumb to overstating: (1) its prevalence; (2) its seriousness (many cases are mild and reversible); and (3) its relevance to the typical refuser, a patient with an acute psychotic episode who needs to be medicated for a brief period during which the risk of contracting TD is virtually nil.

105. Adler, Angrist, Reiter, & Rotrosen. *Neuroleptic-Induced Akathisia: A Review*, 97 PSYCHOPHARMACOLOGY 1 (1989).

which can lead to death. This effect is rare and while alarming, is contextually not out of line. The public does not appreciate the risks of some widely used drugs in general medicine. For example, penicillin allergy can lead to death, and aspirin can lead to fatal gastrointestinal hemorrhage. Conversely, if antipsychotic drugs are not used, there is a risk of developing lethal catatonia. Rather than increase, the risk of death in acutely psychotic patients is substantially *reduced* by the use of antipsychotic drugs. Medical science has made the treatment of mentally ill patients *safer*. Before antipsychotic drugs, electroconvulsive shock treatment was used for many psychotic emergencies. Before electroconvulsive shock was discovered, there was an alarmingly high incidence of death in patients with psychosis from lethal catatonia, suicide, accidents, infection, or other harms which may occur in chronically psychotic patients who are unable to care for themselves.

It is an unfortunate fact that long-term use of antipsychotics can cause a serious and sometimes irreversible neurological condition called tardive dyskinesia. Approximately twenty percent of patients using these drugs for a period in excess of six to seven years develop these symptoms, but these symptoms are severe in a much smaller percentage.<sup>106</sup> The vast majority of patients who receive medication in a hospital are discharged in a few weeks. It is extremely unusual for tardive dyskinesia to develop in the first six months of treatment; so for the typical patient, medication does not raise an appreciable risk of tardive dyskinesia. In the patient who has not previously received neuroleptics, it would be practically impossible to develop true TD within a few weeks of treatment. For the patient who has taken neuroleptics for years, an extra few weeks of treatment would in theory increase the risk of TD, but the increase of risk would be a fraction of one percent.

Those who attack psychotropic medication attack psychiatry for not being sensitive to the problem of TD. This is a justified criticism to the extent that organized psychiatry, the National Institute of Mental Health, and other support agencies were slow to recognize the risk of TD and to fund research for preventive measures. A substantial amount of research

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106. See R. BALDESSARINI, J. COLE, J. DAVIS, G. SIMPSON, & D. TARSY, TASK FORCE REPORT 18: TARDIVE DYSKINESIA (1980). The new American Psychiatric Association Task Force on Tardive Dyskinesia, of which the physician author is a member, will attempt to quantify this. At a recent Task Force meeting, it was the opinion of all the members that the great majority of tardive dyskinesia cases are mild, but there is no doubt that some cases are serious. Among patients with serious cases of TD there are some whose symptoms inexplicably disappear despite continued neuroleptic treatment. For others, the TD will persist even after the medication is discontinued. Although few, these permanent cases are the most alarming. See J.M. KANE, DYSKINESIA: A TASK FORCE REPORT OF THE AMERICAN PSYCHIATRIC ASSOCIATION (1991).

is in progress now.<sup>107</sup> There is a minority of patients who remain continually hospitalized in the long-term wards of state hospitals and refuse any psychotic medication in fear of TD. On occasion, there is court ordered long-term maintenance drug treatment with antipsychotic medication for outpatients.<sup>108</sup> In such situations, the decision whether to override an asserted right to refuse treatment should consider the risk of TD and should balance that risk against the benefits of continuing maintenance medication. We emphasize, however, that almost all patients with an acute episode will be discharged within weeks. For these patients, the risk of TD is essentially absent. Consideration of the risk of TD is important for the few patients who are in long-term institutional treatment and for outpatients for whom the court orders long-term medication. The trouble with much of the legal literature is that it has overlooked the fact that the risk/benefit ratio for short-term drug treatment is altogether different from its long-term administration.<sup>109</sup>

Insofar as failure to adequately treat an acute episode results in a poor outcome and more chronic medication is given, the risk of tardive dyskinesia goes up. Additionally, during the time patients remain untreated while their refusal is being considered by the court or clinical reviewer, many will markedly deteriorate. When an emergency develops, it may be necessary to give patients vigorous, high dosage medication to control the emergency. There is no doubt that neuroleptic malignant syndrome, the most serious of the possible side effects, is more likely to occur with the rapid escalation of dose.<sup>110</sup>

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107. See Davis, *Treatment of Schizophrenia*, 4 CURRENT OPINION IN PSYCHIATRY 28 (1991); Davis & Janicak, *Psychoses*, 4 CURRENT OPINION IN PSYCHIATRY 1 (1991); Davis, *Psychosis: Editorial Overview*, 3 CURRENT OPINION IN PSYCHIATRY 1 (1990); Davis, *Drug Treatment of Schizophrenia*, 3 CURRENT OPINION IN PSYCHIATRY 19 (1990). See also Woerner, *The Prevalence of Tardive Dyskinesia*, 11 J. CLINICAL PHARMACOLOGY 34 (1991).

108. See Bonnie, *Mental Disability Law Crosses a New Frontier: A Review of Recent Developments*, 6 DEV. MENTAL HEALTH L. 22 (1986) (discussing legal basis for compulsory outpatient treatment).

109. The FDA recently approved a new antipsychotic drug, Clozapine, which is apparently risk free for TD and various other effects associated with currently used antipsychotics. However, it has a number of unique risks of its own. See Blackburn, *New Directions in Mental Health Advocacy? Clozapine and the Right of Medical Self-Determination*, 14 MENTAL & PHYSICAL DISABILITY L. REP. 453, 457 (1990).

110. In cases when the wrong medication is given, judicial review is still not the answer. The judge does not have the training to make the correct diagnosis or the proper medication decision. The notion that peer review must take place in the context of an adversarial trial, with the doctors functioning as "expert witnesses," makes little sense from either a theoretical or a practical perspective. For the assertion that Neuroleptic Malignant Syndrome is associated with a rapid increase in dose, see Koek, Pope, Cohen, McElroy, & Nierenberg, *Risk Factors for Neuroleptic Malignant Syndrome*, 46 ARCH. GEN. PSYCHIATRY 914 (1989).

#### *F. Restoring The Mind*

Some claim that the involuntary administration of treatment violates the patient's right of free speech. They advance two arguments: (1) antipsychotic drugs are so sedative or the side effects so severe that they impair mental functioning and (2) they are mind-altering, making the person "different" than he is. With the onset of an episode of illness, the patient's "normal" mental processes change into ones characterized by loose, rambling, illogical, circumstantial, incoherent, inappropriately concrete, and bizarre thought and speech patterns. Delusional ideas may dominate, such as that the government or its particular agencies or personnel are plotting against the patient, or the patient may have vivid visual hallucinations or hear voices that command him to perform certain acts. Evidence from controlled studies shows that antipsychotic drugs correct these aberrations and restore normal thought.<sup>111</sup> For most of a person's life, he develops an integrity of personality characterized by his values, loves and hates, political and philosophic beliefs, religion, interests and dislikes, interpersonal relationships, and vocations and avocations. With mental illness, a person develops delusions and hallucinations different from his normal self and becomes an altered being. It does not make sense to see drugs as the mind-altering agent.

There have been a number of studies which have measured cognitive performance before treatment (drug free) and after treatment in schizophrenics. Performance is significantly improved as a consequence of drug treatment.<sup>112</sup> It is true that some of the antipsychotic drugs have sedative properties, but most are moderately to minimally sedative, and some are not sedative at all. Additionally, the sedation tends to dissipate in a few days. Most importantly, psychosis is often associated with a marked decrement in mental performance. Although the sedative properties of some of these drugs may produce a mild and transient degree of drowsiness, this is more than counterbalanced by the fact that antipsychotic properties correct a serious disturbance of thought; thus, the net effect is that the patient's cognitive powers are much improved after drug treatment.

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111. Hurt, Holzman, & Davis, *Thought Disorder: The Measurement of Its Changes*, 40 ARCH. GEN. PSYCHIATRY 1281 (1983).

112. See Schooler & Goldberg, *Performance Tests in a Study of Phenothiazines in Schizophrenia: Caveats and Conclusions*, 24 PSYCHOPHARMACOLOGIA 81 (1972); Shimkunas, Gynther, & Smith, *Abstracting Ability of Schizophrenics Before and During Phenothiazine Therapy*, 23 ARCH. GEN. PSYCHIATRY 79 (1966); Spohn, Lacoursiere, Thompson, & Coyne, *Phenothiazine Effects on Psychological and Psychophysiological Dysfunction in Chronic Schizophrenics*, 34 ARCH. GEN. PSYCHIATRY, 633 (1977); Wahba, Donlon, & Meadow, *Cognitive Changes in Acute Schizophrenia with Brief Neuroleptic Treatment*, 138 AM. J. PSYCHIATRY 1307 (1981).

### *G. Normal Use vs. Abuse*

Many of the antidrug law review articles discuss at great length the alleged abuse of drug treatment by psychiatrists. What is the point being made? Would the legal community be convinced of the argument that because some lawyers abuse the law or the legal process, we should scrap the system? Of our many social institutions, are there any that operate with complete perfection without room for reform? Scrapping the use of drugs until a judicial hearing four months later is like scrapping the system. We must distinguish between the customary practice of medicine and bad medicine. The right-to-refuse "reform" for involuntary patients is aimed only at bad medicine and penalizes customary medicine and its patients and providers.

There are clear standards for the use of antipsychotic medication. It is unacceptable practice for psychiatrists: (1) to use medication as a punishment; (2) to use drugs to heavily sedate mental patients (although there are rare exceptions to this when temporary sedation is desirable); (3) to use excessively high doses of these medications; or (4) to allow nonmedical personnel to prescribe these medications. There is extensive literature on the proper use of antipsychotic drugs that can be found in various medical articles, as well as in standard medical and psychiatric textbooks, the Physician's Desk Reference, and the American Medical Association's Drug Evaluation monographs.<sup>113</sup> Misuse of drugs is an anathema to the psychiatric profession.

A conceptionally distinct question is whether drugs are, in fact, abused in hospitals, particularly in the state hospitals which are underfunded, where there is a shortage of just about everything and where major resources are squandered in performing meaningless rituals to satisfy the multiple layers of red tape entangling the state hospital system. We doubt that the quality of medical practice in the state hospital system is as high as that in the private sector. Yet, the idea that abusive medicine is the norm is like saying that the public defender or the public prosecutorial system is routinely abusive. Litigation has brought to light individual instances of medical error and abuse in both public and private hospitals. Occasionally, in the past, major systemic shortcomings have also been demonstrated to exist. This is to the good. However, the inference made

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113. *The Physician's Desk Reference* (PDR) is published yearly by the Medical Economy Press and consists of the "package inserts" of ethical medications. This document represents the evaluations of both medical and nonmedical professionals, the pharmaceutical industry, and the FDA; therefore, its exact content may reflect a variety of concerns other than medical science. Nevertheless, it is a consensus document, approved by the FDA. No one source of information (medical texts or the data from scientific studies which shape medical opinion, PDR, AMA Drug Evaluation Monographs, or their equivalents in other countries) represents a single standard, but they produce evidence of established medical practice norms.

by antipsychiatric legal advocates (and in some cases accepted by the courts) that such cases represent normal institutional psychiatry is supported only by the inherently biased artifice of adversarial thinking and pleading. It bears little relation to the contemporary institutional reality or to psychiatry as it is practiced today even under circumstances of resource scarcity and bureaucratic inefficiency.

Ironically, the right-to-refuse movement accuses psychiatry of using drugs as punishment, yet in its one-punch-one-injection approach it in essence favors punitive medicine over a consistent and effective effort to treat the patients. Alternatively, the right-to-refuse treatment movement accuses psychiatrists of using drugs as sedatives, but in restricting the use of antipsychotics to a far-belated point after judicial review, it leaves sedatives as the only medication of the moment for psychosis. Sedatives have no antipsychotic effects. This movement would have the law produce what it criticizes psychiatry for.<sup>114</sup>

### III. THE CASE FOR AN APPROPRIATE PATERNALISM: THE MEDICAL MODEL

The patient's advocate argues that the patient should have as many rights as possible, perhaps even the right to make a rational suicide decision. Legal thought that is uninformed by psychiatric reality generally assumes that the patient's circumstances and the degree of mental illness are constant. This is not the case. The patient may agree to the medication for weeks, but one day suddenly refuse,<sup>115</sup> or he may refuse initially and then cooperate. Rarely are these changes of heart based on rational reasons. Most refusals result from delusional ideas. The constant is that treatment will restore the patient's sanity. On which side should the patient's lawyer come down—the insane self or the sane self?

What if the patient who is delusional and depressed, despite a history of success, decides he has been a failure and it is time to end it all? What if the patient—nonpsychotic but profoundly depressed—who objectively has many things to live for, feels he is a failure and decides on suicide? What if the patient has had a change of personality due to mental illness and decides on some self-destructive course short of suicide, such as not agreeing to effective treatment, and the result is not suicide but life-long hospitalization? In each of these cases, had the patient not been mentally ill, he would have realized that he had really been quite successful in the things he previously did in his life and that the outlook was good. In a normal state, he would not want to commit suicide or remain in the hospital for the rest of his life. His present desires are based on his

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114. See Gutheil & Mills, *supra* note 93, at 19.

115. See, e.g., *Washington v. Harper*, 494 U.S. 210 (1990).

mental illness and do not reflect any of the desires of his entire previous life, except for the two week episode of mental illness. Which side should the lawyer represent, the life-long self or the momentarily altered self?

Medicine has a history of being paternalistic. As the technical experts, doctors have historically done what they conceive is best for the patient, without worrying about the patient's consent or understanding. Patients are beginning to question doctors' paternalism and want to make major decisions about their own lives, based on an understanding of their options, and not to abrogate choice by default. We feel that this is clearly desirable and support it in all but a few exceptional circumstances. There are Good Samaritan or paramedic laws which make it possible for a passerby or paramedic to render first aid to the unconscious victim of a cardiac arrest or accident without fear of liability.<sup>116</sup> Doctors can render emergency treatment to an unconscious patient brought to the emergency room. There are procedures to allow physicians to take care of young children without their parents' permission or to care for clinically obtunded adults or the aged with next-of-kin permission. We feel that the law's conceptualization of the right to mental health treatment and to refuse antipsychotic medication should be analogized to these situations.

Perhaps the best analogy is to the partially unconscious medical patient who, although not completely unconscious, is so obtunded as to lose essentially all rational powers of reasoning. Normally, the emergency room staff makes the determination that the patient is essentially unconscious and renders whatever acute medical treatment is needed to restore the patient's health. There is no judge in the emergency room who passes judgment on the competency of the patient or the decision of the emergency staff. By contrast, a mentally ill person is better protected. He is committed for treatment on a court order after a court hearing. Once that commitment decision is made, however, we should relinquish the fiction that the patient is "fully conscious" or that another "emergency" must develop before he can be treated. We should not turn the desire to protect into over-protection that is harmful. A law that obstructs the right of mentally ill patients to receive effective treatment is a form of discrimination. An indiscriminate upholding of the right to refuse treatment forces the psychiatrist to commit malpractice.<sup>117</sup>

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116. See, e.g., ILL. REV. STAT. ch. 70, para. 61 (1989) (providing immunity from liability for acts of ordinary negligence to police officers and firemen giving emergency assistance to accident victims).

117. It has been suggested that a state physician's decision to honor a clearly incompetent, confined person's refusal to be treated could constitute the kind of "deliberate indifference to serious medical need" that the Constitution prohibits. See *Estelle v. Gamble*, 429 U.S. 97 (1976); *People v. Thomas*, 217 Cal. App. 3d 1034, 266 Cal. Rptr. 295 (1990).

#### IV. IMPLEMENTING AN APPROPRIATE PATERNALISM: A PROPOSAL FOR LEGAL REFORM

Involuntarily committed patients, in most states, are presumed competent unless or until declared incompetent in a subsequent court proceeding separate from the commitment proceeding. This two-stage process requirement is based on a legal fiction because the patients must have been found to be sufficiently lacking in competence with respect to their treatment needs to be committed. Empirically, it has been found that hearings on the right-to-refuse issue (in "medical court") focus on the appropriateness of treatment, rather than the patients' competency.<sup>118</sup> The empirical reality thus recognizes the direct connection between the commitment status and the right to treatment or the right to refuse treatment. The act of commitment to a hospital takes away freedom and can only be based on the fact that these patients suffer from mental illness to such an extent that they will not voluntarily seek appropriate treatment either as outpatients or in a hospital on a voluntary basis. The court in overriding the patient's right to freedom assumes, indeed decides, the patient's incompetence as to treatment decisions. If it were otherwise, the commitment statutes would be merely statutes for preventive detention.

Before there was an effective treatment for the severe mental illnesses, patients were hospitalized mainly for shelter and custody. The purpose was not punishment. Rather, it was recognized that mental illness was indeed an illness and that it was more humane to care for the mentally ill in an asylum than to put them in prison or leave them "free" to fend for themselves and suffer hunger, indignity, or even death. Now that there are effective treatments, psychiatrists view the purpose of hospitalization as treatment, not long-term custodial care. Lawyers, especially those most concerned about patients' interests, should do the same.

The legal analysis should not separate the purpose of involuntary commitment from the right to treatment or the right to refuse treatment. Although state statutes vary in the details, in almost all jurisdictions the *explicit* criteria for involuntary commitment include the following:

- (A) presence of a severe mental disease
- (B) which causes the patient to:
  - (1) be unable to care for himself
  - (2) be likely to do harm to himself
  - (3) be likely to do harm to others.

*Implicit* in all the statutes, in the commitment process itself, is that the individual proposed for commitment is *unwilling* to accept treatment

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118. See Applebaum, *supra* note 71, at 416.

voluntarily, either on an inpatient or outpatient basis. Once the court finds the statutory criteria met and orders commitment, it in effect rules that the patient was not merely unwilling, but *unable* to decide for himself. He was incompetent to make the treatment decision and, therefore, the court exercised its authority to *override* his objection.

What is merely implicit in the statutes of most states has in the last ten years been made explicit in six jurisdictions. Utah has led the way. Its commitment statute includes among its criteria that the court must find that "the patient lacks the ability to engage in a rational decision-making process regarding the acceptance of mental treatment as demonstrated by evidence of inability to weigh the possible costs and benefits of treatment."<sup>119</sup> The statutes of Delaware, Iowa, Kansas, Michigan, and South Carolina contain similar language.<sup>120</sup> The legislatures of these states have drawn the logical conclusion inherent in commitment: the individual's mental state must be such that he cannot make the decision for treatment. His incompetency is, and must be found, simultaneous with his "committability." In addition, the incompetency finding is not undone by the patient's exit from the courtroom door; it extends to his entry into the hospital as a patient committed to the charges of the treating doctors. There is no logic, and should be no legal requirement, to engage in a second legal contest on the same point a few short hours or days after the commitment hearing.<sup>121</sup>

We believe this is the right approach. We do not offer a "model" statute here—only the general principle. The model is available in any of the state statutes listed above, and we urge individual states that presently do not have such provisions to enact them with whatever detail and refinement they see fit. The approach saves valuable time. It will save patients and institutions from potentially incalculable harm. And the patient remains fully protected from a legal standpoint. His treatment rights and needs are fully addressed in the judicial hearing. The approach can even augment protection, as the state may require the hospital to make explicit to the court its treatment and medication plans for the patient.<sup>122</sup>

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119. UTAH CODE ANN. § 62A-12-234(c) (1991).

120. DEL. CODE ANN. tit. 16, § 5001 (1990); IOWA CODE ANN. § 229.1(2) (West 1989); KAN. STAT. ANN. § 59-2917 (1989); MICH. COMP. LAWS § 330.1401(c) (1991); S.C. CODE ANN. § 44-17-580 (Law. Co-op. 1991).

121. See A.E. & R.R. v. Mitchell, 5 Mental Disability L. Rep. 154 (D. Utah, June 16, 1980). The statutes of almost all states permit involuntary commitment only for definite, relatively short periods, bounded by mandatory judicial review. This statutory pattern reduces even further the functional necessity of separate "treatment trials" based on the right to refuse. See generally S. BRAKEL, J. PARRY, & B. WEINER, THE MENTALLY DISABLED AND THE LAW 21-176 (1985).

122. See, e.g., ME. REV. STAT. ANN. tit. 34-B, § 3864(5)(F) (1989).

Thus protected at the point of entering the hospital, both as to his need for and right to treatment, how can the patient be safeguarded subsequently? Again, we will deal in broad strokes, leaving the details for the lawmakers of individual states. First, we propose that the patient's course of treatment be subject to periodic medical-administrative review initiated by the hospital. This proposal presents nothing new, as such review is already mandated by law or administrative regulation in the vast majority of states and state institutions. Additionally, we propose the formalization of a patient-initiated review mechanism so that the patient can articulate his questions and concerns about the course of treatment.<sup>123</sup> The medical-administrative model should apply to this review opportunity as well, and it should also be fixedly periodic, or at least limited in the number of requests permitted over a given span of time, to prevent its exploitation by the chronically complaining patient (we assume that his opposite, the reticent complier who, without a formally granted opportunity to state his case, might never do so, is adequately protected by the state-initiated procedure). Informally, of course, patients are always free to object, discuss, and air complaints about how they are treated at the institution, subject only to the availability and patience of the hospital staff for such discussions. By the same token, members of the treatment staff remain at liberty to explain, give assurances about, and involve patients in treatment decisions, all the way to obtaining *de facto* consent.

The basic principle animating these proposals is that the medical decision model shall apply throughout. The essence of the procedures recommended is that they are administrative and nonadversarial; quick if not necessarily easy. There will be no treatment interruptions or delays and hence no clinical costs (deteriorating patients) or institutional harms (deteriorating hospitals) such as are associated with the legal model. There shall be no judicial review of treatment decisions based on a legal right to refuse. For cases of psychiatric abuse, there are other legal doctrines available that do not carry the pervasive, negative weight of the right-to-refuse concept—malpractice being a prominent one. In the isolated case

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123. We mean real "review" here, not the opportunity for a clinical second-guess of the commitment order that would prohibit treatment to even begin (as in the Oregon and California models). Treatment can be initiated upon hospitalization on the strength of the commitment order, based on whatever treatment decision protocol exists at the institution. The precise reviewing mechanisms and procedures can be modeled on available TRP's such as those prescribed by departmental or institutional regulation (or "policy") in effect in various jurisdictions. See, e.g., *Washington v. Harper*, 494 U.S. 210 (1990); *United States v. Charters*, 863 F.2d 302 (4th Cir. 1988). There are, of course, costs involved in implementing such clinical review, but they are worth bearing if the procedure is appropriately targeted and limited.

when the conscientious legal advocate sees a need to force a change in the course of treatment over the judgment of the medical services provider to legally compel more appropriate or less intrusive treatment, it can be done on the basis of available, more positive concepts than the right to refuse. The right-to-treatment doctrine and the least restrictive alternative concept—properly applied with concern for the patient's medical and personal interests, as opposed to just his technical legal rights—are mechanisms adequate for this purpose.

#### V. CONCLUSION: THE TRUE PATIENT'S ADVOCATE

Our rejection of the legal separation between involuntary commitment and competency and thus of the involuntary patient's right to refuse treatment may be viewed as an attempt to turn back the clock. There will be those who will charge that we advocate a regression in the law. So be it. Our comfort with this proposal lies in the conviction that not all that passes (or has passed) for progress is truly progress. Thus not all "regress" is bad. We believe that turning back the legal clock on this particular matter comports with both the patient's and society's best interest, not to mention common sense.<sup>124</sup>

We feel the patient has a right to receive treatment in order to regain both health and "competency" and that this right needs to be balanced against any right to refuse treatment. One cannot separate involuntary hospitalization from involuntary treatment. It is like having one court decide to take a patient to the operating room and give anesthesia, and then having another court decide whether to operate.

Consideration by legal practitioners of the consequences of the patient's right to refuse treatment is essential for truly adequate representation of the client. The total picture—the patient's total interests, not just his legal entitlements—must be seen. Routine judicial review of treatment decisions is both conceptually inappropriate and practically wasteful of precious time. Patients who receive treatment early on usually recover in a few weeks and can be discharged with freedom fully restored. Those who do not receive treatment may have the dubious satisfaction of seeing their right to refuse treatment held intact, but it comes at a cost of the loss of all other liberties as they stagnate or deteriorate as inpatients, indefinitely or in some cases, permanently. Given no prospect or requirement for speedy judicial review, the treated patient will be recovered and home before the refuser even has his day in court. The untreated patient remains

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124. One may be tempted to say "communitarian" sense, in deference to the newly coined term for the hardly new idea that excessive libertarianism and excessive deference to special interests, particularly as pleaded by the self-designated representatives of these interests, often poorly serve the common good or even the true holders of these interests.

committed to the institution. The State protects his right to refuse treatment but takes away everything else.

The constitutional and other legal justifications for a right to refuse treatment with antipsychotic medications must be viewed in the context of the medical consequences to the patient which demonstrably result from the exercise of that right. Really to do "justice" to the client, the legal advocate must consider the pertinent medical facts before advising the client or client's family. To preserve the client's right to refuse medication, only to have that client permanently deprived of all other liberties, cannot be in the client's interest and cannot be what he wants. When the medical professional moves to temporarily abridge a singular right, so that health and freedom (and all other rights) may be restored quickly, he is assuredly promoting the patient's welfare. No attorney whose goal is to represent mentally ill clients to the limit of his professional ability and ethic can afford to ignore this point.<sup>125</sup>

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125. For a harshly judgmental account, written by nonlawyers, of the mental health bar's prevailing conception of what constitutes competent and ethical service of its clientele, and the results attributed to the implementation of this view, see R. ISAAC & V. ARMAT, *MADNESS IN THE STREETS: HOW PSYCHIATRY AND THE LAW ABANDONED THE MENTALLY ILL* (1990). See also Brakel, 1981 *Legal Aid in Mental Hospitals*, AM. BAR FOUND. RES. J. 21 (1981); Brakel, *The Role of the Lawyer in the Mental Health Field*, 1977 AM. BAR FOUND. RES. J. 467 (1977); Galie, *An Essay on the Civil Commitment Lawyer: Or How I Learned to Hate the Adversary System*, 6 J. LAW & PSYCHIATRY 71 (1978).



# Indiana Law Review

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Volume 25

1991

Number 2

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## NOTES

### Are the Accountants Accountable? Auditor Liability in the Savings and Loan Crisis

#### INTRODUCTION

From 1980 to 1988, over 500 savings associations failed throughout the United States, more than three-and-a-half times the number of savings associations that had failed in the previous forty-five years combined.<sup>1</sup> As a result of the federal government's bailout of failed thrifts, the savings and loan (S&L) crisis could ultimately cost American taxpayers one trillion dollars, amounting to thirty dollars a month for every household over the next four decades (roughly equivalent to twice the cost of the Vietnam War or four times the cost of the Korean conflict).<sup>2</sup> Even under more conservative estimates, industry analysts warn that the S&L debacle could cost American taxpayers \$500 to \$700 billion<sup>3</sup> and

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1. S. REP. No. 19, 101st Cong., 1st Sess. 2 (1989). See also Clark, Murtagh, & Corcoran, *Regulation of Savings Associations Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 BUS. LAW. 1013, 1013 (1990).

2. Greenwald, *S&L Hot Seat: Thrift Honchos Squirm and Politicians Dither as the Economy Slides*, TIME, Oct. 1, 1990, at 34.

3. The estimates for the ultimate cost of the S&L bailout continue to increase. In October 1990, William Seidman, Chairman of the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) estimated that the cost of the S&L bailout, including interest, could reach \$600 billion. Reuters, *Cost of S&L Bailout May Reach \$600 Billion*, CHRISTIAN SCIENCE MONITOR, Oct. 1, 1990, at 9, col. 2. Other estimates suggested that the bailout would cost \$500 billion. Garsson, *Half the Public Never Heard of Thrift Crisis or Costly Bailout*, AM. BANKER, Oct. 3, 1990, at 7. By mid-1991, Chairman Seidman raised his estimate and predicted that the cost of the S&L bailout could reach \$700 billion — \$225 to \$250 billion plus interest over 30 to 40 years. *Frontline: The Great American Bailout* (PBS television broadcast, Oct. 22, 1991) (transcript available from Journal Graphics, 1535 Grant Street, Denver, Colorado, 80203). To indicate the magnitude of a \$250 billion bailout (excluding interest), in 1990, the federal government spent less than half of this amount on NASA, the FBI, the EPA, the Veterans Administration, the War on Drugs, Headstart, Prenatal Health Care, AIDS research, and the entire Persian Gulf War (\$61 billion) combined. *Id.*

could cost each American household \$5,000.<sup>4</sup>

As the Federal Deposit Insurance Corporation (FDIC) seeks to recover failed thrift losses and as public pressure mounts to identify, prosecute, and punish the individuals involved, attention is increasingly focusing on the liability of accountants and other professionals for their roles in the savings and loan crisis. Judge Sporkin recently observed in *Lincoln Savings and Loan Association v. Wall*:<sup>5</sup>

Where were these professionals, a number of whom are now asserting their rights under the Fifth Amendment, when these clearly improper transactions were being consummated?

Why didn't any of them speak up or disassociate themselves from the transactions?

Where also were the outside accountants and attorneys when these transactions were effectuated?

What is difficult to understand is that with all the professional talent involved (both accounting and legal), why at least one professional would not have blown the whistle to stop the over-reaching that took place in this case.<sup>6</sup>

Before examining the liability of certified public accountants for their audits of now-failed savings and loan institutions, it should be noted that this topic has several different dimensions (legal, economic, administrative, and political), each individually of incredible magnitude, yet all closely interconnected. First, as for its legal dimension, the applicable area of accountant liability law is currently in a state of transition (as evidenced by the recent developments in accountants' liability to third parties).<sup>7</sup> Second, this topic's economic dimension involves nothing less than one of the major financial crises of the century.<sup>8</sup> Third, as for its administrative dimension, because accountants audited governmentally regulated entities —S&Ls— there is the added element of federal regulation and recently reorganized governmental structures. Finally, as for its political dimension, this topic must also be approached with an understanding of the influence of political philosophies and

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4. Francis, *S&L Cleanup Avoids Cause of Crisis*, CHRISTIAN SCIENCE MONITOR, Sept. 28, 1990, at 8, col. 2.

5. *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901 (D.D.C. 1990) (suit brought by Lincoln Savings and Loan Association against the director of the Office of Thrift Supervision, M. Danny Wall, for the federal regulators' take-over of Lincoln).

6. *Id.* at 920.

7. See, e.g., Bagby & Ruhnka, *The Controversy Over Third Party Rights: Toward More Predictable Parameters of Auditor Liability*, 22 GA. L. REV. 149 (1987).

8. P. PILZER & R. DEITZ, OTHER PEOPLE'S MONEY: THE INSIDE STORY OF THE S&L MESS 15 (1989).

actions, both past and present. Moreover, an analysis of accountants' liability for audits of S&Ls also has implications for accountants' liability for audits of other financial institutions (such as audits for the Bank of Credit and Commerce International (BCCI), other failed banks, corporations, and insurance companies).

With such a perspective, this Note examines the liability of independent certified public accountants (CPAs) for their role as auditors of savings and loan institutions declared insolvent during the S&L crisis. Part I traces the development of the savings and loan crisis. Part II discusses the auditing process and examines the role of accountants in auditing savings and loan institutions. Part III summarizes the congressional responses to alleged accountant misconduct in the savings and loan crisis. Part IV analyzes potential lawsuits against accounting firms for their audits of now-failed S&Ls, focusing on potential parties, causes of action, arguments, and legal defenses. Finally, Part V concludes the analysis of accountants' liability in the savings and loan crisis.

## I. HISTORY OF THE SAVINGS AND LOAN CRISIS

### A. *Deregulation of "Sleepy" Savings and Loan Institutions*

Savings and loan institutions were originally established in the 1930s to offer home loans for Americans seeking the "American dream" of home ownership.<sup>9</sup> During the period between the Great Depression and the 1960's, these institutions were profitable because they offered traditional low-risk, long-term home loans and paid low interest rates on savings deposits.<sup>10</sup> In 1966, Congress enacted legislation which, for the first time, set a ceiling on the interest rates that S&Ls could pay depositors.<sup>11</sup> During the 1970's, when higher oil prices caused double-digit inflation and rapidly escalating interest rates, S&Ls became less

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9. Goldwasser, *The Liability Ramifications of the S&L Crisis*, 60 CPA J., 20, 22 (1990). For general background reading on the savings and loan crisis, see J. ADAMS, THE BIG FIX: INSIDE THE S&L SCANDAL (1990); M. MAYER, THE GREATEST-EVER BANK ROBBERY: THE COLLAPSE OF THE SAVINGS AND LOAN INDUSTRY (1990); P. PILZER & R. DEITZ, *supra* note 8; S. PIZZO, M. FRICKER, & P. MUOLO, INSIDE JOB: THE LOOTING OF AMERICA'S SAVINGS AND LOANS (1989); M. WALDMAN, WHO ROBBED AMERICA?: A CITIZEN'S GUIDE TO THE SAVINGS & LOAN SCANDAL (1990). See also Wayne, *Where Were the Accountants?*, N.Y. Times, Mar. 12, 1989, § 3, at 1, col. 2.

10. Clark, Murtagh, & Corcoran, *supra* note 1, at 1019. See also Roberts & Cohen, *Villains of the S&L Crisis*, U.S. NEWS & WORLD REPORT, Oct. 1, 1990, at 53, 54.

11. Pub. L. No. 89-597, 80 Stat. 823 (1966). See also Clark, Murtagh, & Corcoran, *supra* note 1, at 1019 (S&L interest rate ceilings were codified in the Federal Reserve System's Regulation Q).

competitive because they were limited by federal regulations to paying only 5.5% interest.<sup>12</sup> Consequently, many depositors shifted their assets from low interest S&Ls to higher return investments (such as money market mutual funds), causing S&Ls to lose deposits rapidly.<sup>13</sup>

In March of 1980, in an attempt to make S&Ls more competitive, Congress passed (and Jimmy Carter signed) the Depository Institutions Deregulation and Monetary Control Act,<sup>14</sup> which raised the interest rate ceiling for S&Ls, lowered the capital reserves thriffts were required to keep on hand (from five percent to four percent), and with virtually no analysis or scrutiny, raised the amount of federal deposit insurance for S&Ls, banks, and credit unions from \$40,000 to \$100,000 per account.<sup>15</sup> As a result, the legislation increased the government's exposure to risk by 250% in the event of financial institution failure.<sup>16</sup>

When thriffts began paying more competitive interest rates on such "risk-free" deposits, Wall Street brokers were attracted by these lucrative opportunities and began packaging their own investments into insurable \$100,000 chunks, shopping around the country for the highest interest rates, and dispatching deposits to S&Ls through a network of computerized transfers.<sup>17</sup> The ensuing war among institutions to raise interest rates in order to attract these "brokered deposits" severely strained many S&Ls. Even though S&Ls could now pay any rate to attract depositors (nearly twenty percent in some cases), they were receiving less than a ten percent return on their long-term home loans, which constituted the bulk of their assets.<sup>18</sup> According to one estimate, by 1981, eighty-five percent of thriffts were on the brink of collapse.<sup>19</sup>

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12. Moore, *The Bust of '89*, U.S. NEWS & WORLD REPORT, Jan. 23, 1989, at 36, 38.

13. Roberts & Cohen, *supra* note 10, at 54. See also Moore, *supra* note 12, at 38.

14. Monetary Control Act of 1980, Pub. L. No. 96-221, 94 Stat. 132.

15. Gail & Norton, *A Decade's Journey From "Deregulation" to "Supervisory Regulation": The Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 45 Bus. LAW., 1103, 1104 (1990). See also Roberts & Cohen, *supra* note 10, at 54.

16. Moore, *supra* note 12, at 38. Such extended government liability has been widely criticized. See Kane, *Proposals to Reduce FDIC and FSLIC Subsidies to Deposit-Institution Risk-Taking*, 8 ISSUES IN BANK REG. 24, 31 (1985). See also Richter, *A Risky System for Deposits*, L.A. Times, Sept. 9, 1990, p. 1, col. 1 ("[A] family of four can legally open fourteen insured accounts worth \$1.4 million at a single institution.").

17. Roberts & Cohen, *supra* note 10, at 55. See also Moore, *supra* note 12, at 38; Richter, *supra* note 16, at 1.

18. Richter, *supra* note 16, at 1. See also Clark, Murtagh, & Corcoran, *supra* note 1, at 1020; Moore, *supra* note 13, at 38.

19. Cope, *Did Pratt's Piloting Sink S&L Industry?*, AM. BANKER, Oct. 1, 1990, at 1. See also Roberts & Cohen, *supra* note 13, at 54 (Only two years after the 1980 bill, the capital reserves of the thrift industry plunged from \$31 billion to \$4 billion.).

In 1981, Ronald Reagan assumed the Presidency, and in keeping with his devotion to the principles of deregulation, he led the move to deregulate the thrift industry even further.<sup>20</sup> As a result, the Federal Home Loan Bank Board (FHLBB) permitted S&Ls to make accounting changes which masked their growing insolvency.<sup>21</sup>

In addition to federal deregulation efforts, some states, particularly Texas, California, and Florida, enacted laws deregulating state-chartered S&Ls.<sup>22</sup> State-chartered S&L owners could now choose to operate under either federal or state restrictions which, for practical purposes, meant many selected the most lenient restrictions.<sup>23</sup>

In 1982, Congress passed (and President Reagan signed) the Garn-St Germain Act.<sup>24</sup> This deregulation law expanded the powers of federally chartered thrifts, allowed S&Ls to invest in high-risk, high-return ventures, and gave thrifts lending powers not granted to even more so-

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20. Roberts & Cohen, *supra* note 10, at 55.

21. *Id. See also* Cope, *supra* note 19, at 2. Under Richard Pratt, head of the FHLBB, relief measures were taken with the following results:

- a. capital requirements were cut further from 4% to 3% of assets;
- b. S&Ls were allowed to count intangible capital such as "goodwill"; thus when stronger thrifts merged with insolvent thrifts, the stronger thrifts were allowed to count the insolvent's intangible capital ("goodwill") which inflated the acquirer's "paper assets";
- c. S&Ls were permitted to exclude subordinated debt from their liabilities in calculating regulatory net worth and the exposure of the insurance fund. Similarly, S&Ls were also permitted to increase their assets and thus their regulatory net worth (which measures the exposure of the insurance fund) by the unrealized appreciation in value of land and buildings;
- d. S&Ls deferred loan losses, postponing the recognition of those losses;
- e. S&Ls kept even less than the required 3% of assets on hand by adjusting the way in which capital requirements were determined; they calculated capital requirements against the average asset balance of the past five years to arrive at higher capital assets.

Cope, *supra*, at 55.

22. *Failure of Independent CPA's to Identify Fraud, Waste and Mismanagement and Assure Accurate Financial Position of Troubled S&Ls: Hearings Before the Committee on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess., 30 (1989) [hereinafter *CPA Hearing*] (statement of John J. LaFalce, member of the House of Representatives). *See also* Roberts & Cohen, *supra* note 10, at 55.

23. Roberts & Cohen, *supra* note 10, at 55 (two-thirds of the industry's losses can be attributed to state-chartered thrift failures). *See also* Clark, Murtagh, & Corcoran, *supra* note 1, at 1021 ("In particular, several states granted state-chartered savings associations the authority to invest in equity securities, unrated corporate debt securities, and real estate development projects of a type, or in an amount, that would have been impermissible for federal savings associations.").

24. Garn-St Germain Depository Institutions Act of 1982, Pub. L. 97-320, 96 Stat. 1469.

phisticated commercial banks.<sup>25</sup> In addition, regulators' changes in the loan-to-value regulations enabled S&Ls to lend up to 100% of the appraised value of a commercial real estate development project, even if the actual purchase price was much smaller.<sup>26</sup> Consequently, a real estate developer could now purchase property, secure an inflated appraisal stating that the property was worth 150% of the purchase price, then easily borrow the full inflated amount from an S&L.<sup>27</sup> Under such conditions, inflated appraisals were not difficult for developers to obtain.<sup>28</sup>

Federal officials continued to deregulate the thrift industry by removing other "safety nets." Rules requiring S&Ls to be owned by multiple shareholders, living in geographical proximity to the S&L, were abandoned, thus allowing S&Ls to be owned by single investors.<sup>29</sup> Meanwhile, federal examiners cut back significantly on policing the S&L industry.<sup>30</sup>

### *B. Speculation and Unscrupulous Transactions*

The effect of deregulation was that thrifts could be owned by single investors who could loan money at higher interest rates and invest in speculative ventures with less regulatory supervision, yet such owners were backed with government-guaranteed federal deposit insurance.<sup>31</sup> In this "no-lose" situation, some S&Ls were purchased by aggressive entrepreneurs who used S&L funds to finance their own ventures, and in

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25. Moore, *supra* note 12, at 38 (S&Ls were permitted to make "high-risk acquisition, development and construction loans [ADC loans], to form development subsidiaries and make direct investments").

26. 48 Fed. Reg. 23032, 23037 (1983). *See, e.g.*, Complaint of Plaintiff at 14, Sunbelt Sav. Ass'n of Texas v. McBirney, No. 88-6955 (N.D. Tex. filed June 2, 1988) [hereinafter Complaint, Sunbelt v. McBirney] (pending \$200 million suit against accounting firm Grant Thornton for its audits of Sunbelt Savings Association and Sunbelt Service Corp. in Dallas, Texas); Complaint of Plaintiff at 14, FDIC v. Schoenberger, No. 89-2756 (E.D. La. filed June 19, 1989) [hereinafter Complaint, FDIC v. Schoenberger] (pending \$40 million suit against accounting firm J. K. Byrne & Co. for its audits of Crescent Federal Savings Bank in New Orleans, Louisiana). *See also* Moore, *supra* note 12, at 38.

27. Moore, *supra* note 12, at 38. *See also CPA Hearing, supra* note 22, at 85-86 (statement of Mr. Thomas Myers, President of T.A. Myers & Co.) ("The joke was that you drive into the drive-up window at Sunrise Savings and Loan, they would throw a bag of money and a loan application.").

28. Moore, *supra* note 12, at 38.

29. Roberts & Cohen, *supra* note 10, at 55.

30. Clark, Murtagh, & Corcoran, *supra* note 1, at 1022 ("In some instances, this reduction in regulatory scrutiny was the result of a conscious effort to deregulate; other times it was the result of inadequate staffing at both the federal and state levels."). *See also* Roberts & Cohen, *supra* note 10, at 55.

31. Roberts & Cohen, *supra* note 10, at 55.

some cases, ignored the rules that remained after deregulation.<sup>32</sup> These circumstances were summarized in their popular motto "Heads, I win; tails, FSLIC loses," because they were assured that the Federal Savings and Loan Insurance Corporation would underwrite their losses in the event of the thrift's failure.<sup>33</sup>

Consequently, some S&L operators ran their institutions more like speculative real estate investment companies than federally insured financial institutions.<sup>34</sup> Although some of these aggressive new operators made speculative acquisition development and construction loans (ADC loans)<sup>35</sup> and invested in highly speculative ventures (spanning a range from junk bonds to bull-sperm banks and shopping centers in the desert),<sup>36</sup> the most unscrupulous operators developed schemes to inflate the S&L's net worth artificially. Some of the more common transactions were "land-flips" in which worthless parcels of land were traded back and forth, increasing in value with each exchange,<sup>37</sup> "tax-sharing

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32. Goldwasser, *supra* note 9, at 23.

33. *CPA Hearing*, *supra* note 22, at 60. See also Moore, *supra* note 12, at 38.

34. E.g., Complaint, Sunbelt v. McBirney, *supra* note 26.

35. E.g., Complaint, FDLIC v. Schoenberger, *supra* note 26.

36. Roberts & Cohen, *supra* note 10, at 55. See also First Amended Complaint of FSLIC at 25, FSLIC v. Fitzpatrick, No. 86-6780 RMT (Tx) (C.D. Cal. filed Mar. 13, 1987) [hereinafter Complaint, FSLIC v. Fitzpatrick] (settled suit against accounting firm Touche Ross & Co. for its audits of Beverly Hills Savings and Loan in Beverly Hills, California).

37. Under the "land flip" scheme, S&L operators would sell seemingly worthless land back and forth to each other, each time inflating the price. It has been reported that during a "land flip," one speculator

would line up his cronies and take a piece of vacant land worth maybe \$125,000.

A first set of buyers would pay \$200,000 and then turn around and sell it for \$400,000. The second buyer would immediately resell for \$600,000, and so on until, by the end of the day, the parcel may have gone through six sales and wind up with a 'market' value, supported by courthouse records, of \$2 million or so.

J. ADAMS, *THE BIG FIX: INSIDE THE S&L SCANDAL* 205 (1990). See also *CPA Hearing*, *supra* note 22, at 19; First Amended Complaint of Plaintiff at 31, FSLIC v. Jacoby, No. 86-1894, (S.D. Fla. filed Dec. 6, 1988) [hereinafter Complaint, FSLIC v. Jacoby] (pending \$250 million suit against accounting firm Deloitte, Haskins & Sells for its audits of Sunrise Savings and Loan in West Palm Beach, Florida).

In *Who Robbed America: A Citizen's Guide to the Savings and Loan Scandal*, the author described the recollections of a real estate salesperson who later pleaded guilty to criminal charges in the S&L probe. The "land-flip" participant stated:

I remember one closing we had, . . . . It was in the hall of an office building. The tables were lined all the way down the hall. The investors were lined up in front of the tables. The loan officers would close one sale and pass the papers to the next guy. It looked like kids registering for college. If any investor raised a question, someone would come over and tell them to leave, they were out of the deal.

M. WALDMAN, *supra* note 9, at 35-36.

schemes" in which an S&L was deliberately pillaged for the benefit of a parent holding company,<sup>38</sup> or "cash for trash" transactions in which an S&L eliminated worthless real estate from its financial records to avoid a reduction in the institution's net worth.<sup>39</sup> These unscrupulous S&L owners often lived in opulence,<sup>40</sup> and were generous contributors to political campaigns.<sup>41</sup>

In 1984, oil prices fell dramatically, leading to an economic downturn in the oil-producing states of the Southwest.<sup>42</sup> As a result, the real estate

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38. E.g., *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901, 909 (D.D.C. 1990). This "tax-sharing" scheme was used by S&L owners who also owned other parent companies. They looted the S&L by transferring cash to the parent company, ostensibly to help the parent company meet its payments to the IRS. In fact, the cash was kept by the parent company for other purposes. In *Lincoln*, it was found that from 1984-1987, Lincoln sent \$94 million to its parent company American Continental Corporation (ACC). Judge Sporkin wrote that "[t]his so-called tax sharing agreement was nothing more than a clever but impermissible way of looting Lincoln by upstreaming funds from Lincoln to ACC." *Id.*

39. Wayne, *Showdown at "Gunbelt" Savings*, N.Y. Times, Mar. 12, 1989, § 3, at 1-2, col. 2. In *Inside Job: The Looting of America's Savings and Loans*, "cash-for-trash" deals are described as follows:

In a cash-for-trash transaction, a thrift officer said, in effect, "We'll make you the loan you want, on the condition that you use the extra money we loan you to buy a piece of repossessed real estate we have on our books." Cash-for-trash schemes were popular among poorly run and crooked savings and loans because as long as the thrift could keep reselling repossessed properties to phony buyers (thereby hiding their past mistakes), and collect phony fees and make a phony profit, it could hold off suspicious federal auditors.

S. PIZZO, M. FRICKER, & P. MUOLO, *supra* note 9, at 353. See also Complaint, Sunbelt v. McBirney, *supra* note 26, at 19; M. WALDMAN, *supra* note 9, at 37.

40. One of the most notorious S&L owners was Edwin T. McBirney III, Chairman of Sunbelt Savings Association, who owned a fleet of seven aircraft, bought 84 Rolls-Royces from Bhagwan Shree Rajneesh (an Indian guru in Oregon), and built a "gleaming moonscape skyscraper" known as Sunbelt's "intergalactic headquarters." McBirney also earned a reputation for throwing extravagant parties, spending \$1.3 million for Halloween and Christmas parties in 1984-1985. Moore, *supra* note 12, at 40.

Another notorious S&L operator, Don Ray Dixon, owner of Vernon Savings and Loan in Vernon, Texas, liked exotic cars and \$2 million beach houses, and went on an 1983 "eating trip" through Europe in which Dixon conducted a "market study" of world-class restaurants, all paid for by Vernon Savings and Loan. J. ADAMS, *supra* note 37, at 218. See also CPA Hearing, *supra* note 22, at 69.

41. Roberts & Cohen, *supra* note 10, at 58. See also M. WALDMAN, *supra* note 10, at 60-82. Charles Keating of Lincoln Savings and Loan made generous contributions to politicians and expected his employees to do the same. As stated in the *Chicago Tribune*, "Politicians would visit Lincoln Savings and Loan, and the next day a stack of checks would be forwarded . . . . Arizona senator John McCain received 51 donations from Keating family members and employees all on the same day." Lavin, *Charlie's Web*, Chicago Tribune, Jan. 14, 1990, at C1. It is also interesting to note that Charles Keating donated over one million dollars to Mother Teresa. *Id.* at C9.

42. Goldwasser, *supra* note 9, at 23.

boom in the Southwest ended, foreclosures increased, and approximately 200 S&Ls failed and were taken over by the Federal Savings and Loan Insurance Corporation (FSLIC).<sup>43</sup>

### C. Reregulation of Savings and Loan Institutions

In 1985, the Federal Home Loan Bank Board (FHLBB), led by Edwin Gray, began to "reregulate" S&Ls. The FHLBB hired hundreds of new examiners, increased capital requirements of S&Ls, established growth limitations, attempted to limit brokered deposits, and banned inflated appraisals.<sup>44</sup> When property was reappraised at current depressed market values, foreclosures increased, and even more S&Ls were declared insolvent.<sup>45</sup>

Due to the high number of S&L insolvencies, the FSLIC's funds were depleted by 1986, rendering it unable to close troubled S&Ls or to reimburse depositors.<sup>46</sup> As a result, hundreds of insolvent and nearly insolvent S&Ls continued to operate and incur losses estimated at over twenty million dollars per day.<sup>47</sup>

## II. THE ROLE OF ACCOUNTANTS IN THE SAVINGS AND LOAN CRISIS

### A. The Auditing Process

During these dramatic changes in the thrift industry, the Federal Home Loan Bank Board continued to require annual audits of S&Ls by independent certified public accountants.<sup>48</sup> Traditionally, an audit constituted "a verification of the financial statements of the institution through an examination of the underlying accounting records and sup-

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43. *Id.*

44. Moore, *supra* note 12, at 41.

45. *Id.*

46. The FSLIC had a negative net worth of approximately \$6.3 billion in December 31, 1986, which dropped to a negative \$13.7 billion in December 31, 1987. *Condition of the Federal Deposit Insurance Funds Before the House of Representatives Comm. on Banking, Finance and Urban Affairs*, 100th Cong., 2nd Sess. 185 (1988) (statement of M. Danny Wall, Chairman, Federal Home Loan Bank Board).

47. Clark, Murtagh, & Corcoran, *supra* note 1, at 1014. However, even when FSLIC did not liquidate ailing thrifts, it usually replaced S&L management, and regulators placed thrifts under tight supervisory controls. Telephone interviews with Anne Buxton Sobol, former Assistant General Counsel of the Federal Deposit Insurance Corporation (Oct. 18, 1990, Nov. 2, 1990, Nov. 15, 1990, Nov. 20, 1990, Aug. 22, 1991, Oct. 6-7, 1991).

48. 12 C.F.R. § 571.2 (1991).

porting evidence.”<sup>49</sup> During an audit, accountants agree to examine the institution’s financial statements in accordance with the Generally Accepted Auditing Standards (GAAS) and Generally Accepted Accounting Principles (GAAP).<sup>50</sup> One of four types of audit reports may be issued

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49. Hagen, *Certified Public Accountants’ Liability for Malpractice: Effect of Compliance with GAAP and GAAS*, 13 J. CONTEMP. L. 65, 66 (1987). An audit typically consists of the following five stages:

- (1) planning the audit;
- (2) making a preliminary evaluation of the institution’s internal control system;
- (3) conducting compliance tests to determine whether the institution’s internal control system functions properly;
- (4) adjusting the audit program to conform with the results of the compliance tests; and
- (5) issuing a written report in which the auditor evaluates whether or not the institution’s statements fairly reflect its financial condition.

*Id.* at 67-68.

50. The AICPA has issued Generally Accepted Auditing Standards (GAAS) that are standard auditing methods and procedures which govern audits conducted by CPAs. These standards also include Statements on Auditing Standards which interpret the Generally Accepted Auditing Standards (GAAS). *Id.* at 72-73. The Generally Accepted Auditing Standards are as follows:

*General Standards*

1. The audit is to be performed by a person or persons having adequate technical training and proficiency as an auditor.
2. In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors.
3. Due professional care is to be exercised in the performance of the audit and the preparation of the report.

*Standards of Field Work*

1. The work is to be adequately planned and assistants, if any, are to be properly supervised.
2. A sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed.
3. Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under audit.

*Standards of Reporting*

1. The report shall state whether the financial statements are presented in accordance with the generally accepted accounting principles.
2. The report shall identify those circumstances in which such principles have not been consistently observed in the current period in relation to the preceding period.
3. Information disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report.
4. The report shall either contain an expression of opinion regarding the financial statements, taken as a whole, or an assertion to the effect that an opinion cannot be expressed. When an overall opinion cannot be expressed, the reasons therefore should be stated. In all cases where the auditor’s name is associated

at the conclusion of the audit: (1) an unqualified opinion ("clean audit"); (2) a qualified opinion; (3) an adverse opinion; or (4) a disclaimer opinion.<sup>51</sup> An unqualified opinion is an accountant's opinion without any exceptions, reservations, or qualifications that the financial statements of the institution fairly represent its financial position.<sup>52</sup> A qualified opinion and an adverse opinion are those given when the institution has used an improper accounting treatment for one or more items, and thus its financial statements do not comply with Generally Accepted Accounting Principles (GAAP).<sup>53</sup> Finally, a disclaimer is the harshest judgment, indicating that the institution's financial records are so inadequate that the auditors cannot render an opinion.<sup>54</sup>

In spite of widespread agreement on the mechanics of an audit, there is, however, considerable disagreement concerning the proper role of an independent certified public accountant. Essentially, there is disagreement as to whether an accountant owes ultimate allegiance to the public or to the client and disagreement as to whether an audit can be expected to reasonably assure that the financial statements are accurate. Accountants frequently refer to this as the "expectation gap" between public perceptions and the realities of an auditor's role.<sup>55</sup>

Traditionally, in planning, conducting, and reporting audits, accountants have been expected to adhere to the principles of "conservatism, skepticism, and independence."<sup>56</sup> In *United States v. Arthur Young & Co.*,<sup>57</sup> the United States Supreme Court stated that an auditor's responsibility to the public transcends an auditor's employment relationship with the client, thus requiring an auditor to maintain total independence from the client.<sup>58</sup> In *Arthur Young*, Chief Justice Burger described this "public watchdog" role:

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with financial statements, the report should contain a clear-cut indication of the character of the auditor's work, if any, and the degree of responsibility the auditor is taking.

Silver, *Compilations, Reviews, and Audits/The Audit Process*, ACCOUNTANTS' LIABILITY: A.L.I.-A.B.A. COURSE OF STUDY MATERIALS 51, 59-60 (Jan. 31 - Feb. 1, 1991).

51. Hagen, *supra* note 49, at 69-71.

52. *Id.* at 69.

53. The difference between a qualified opinion and an adverse opinion is "the degree of materiality of the deficiency in the financial statements." *Id.* at 70.

54. Wayne, *supra* note 9, at 1. See also Hagen, *supra* note 49, at 71.

55. See CPA Hearing, *supra* note 22, at 79. See also Morrison, *The Difficulties Facing Today's Bank and Savings and Loan Association Auditor: An Auditor's Perspective*, 653 PRAC. L. INST. 135 (1989); Neebes, Guy, & Whittington, *Illegal Acts: What are the Auditors' Responsibilities?*, 171 J. OF ACCT. 89 (1991).

56. See CPA Hearing, *supra* note 22, at 58 (statement of Thomas Bloom, former chief accountant for the Federal Home Loan Bank Board).

57. 465 U.S. 805 (1984).

58. *Id.* at 817.

An independent certified public accountant performs a different role. By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to [the] investing public. This "public watchdog" function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.<sup>59</sup>

However, even if accountants accept this "public watchdog" role and accept ultimate allegiance to the public, accountants still caution against complete or unreasonable reliance upon audits, arguing that an audit cannot guarantee that an institution's financial records are accurate. As expressed by the Commission on Fraudulent Financial Reporting in its 1987 report:

[A]n audit cannot and does not guarantee or provide absolute assurance that the financial statements are reliable and accurate. These clarifications will help to confirm to all concerned that management has primary responsibility for the financial statements and to protect users of financial statements from placing more reliance on the audit process than is reasonable.<sup>60</sup>

Thus, there is a tension at the heart of the auditing process between an accountant's ultimate allegiance to the public or to the client. Moreover, regardless of the primary allegiance owed by the auditor, there remains an unresolved issue of just how accurate the audit is purporting to be, and therefore, what degree of reliance on the audit is reasonable.

### *B. Indications of Accountant Misconduct in Auditing S&Ls*

Throughout the evolution of the S&L crisis, some S&Ls were audited by accounting firms and were given "clean audits" only to be declared insolvent shortly thereafter.<sup>61</sup> In California, for example, twenty-nine of thirty-one insolvent S&Ls were given "clean audits" by their accounting firms.<sup>62</sup> Similarly, in the FDIC's suit against accounting firm Ernst & Young (formerly Arthur Young) for the accountants' audits of Western

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59. *Id.* at 817-18.

60. *CPA Hearing, supra* note 22, at 162 (written statement of William L. Gladstone, Chairman of Arthur Young & Company, quoting The Report of the National Commission on Fraudulent Financial Reporting, Oct. 1987).

61. Wayne, *supra* note 9, at 12.

62. Roberts & Cohen, *supra* note 10, at 59.

Savings & Loan in Dallas, Texas, the FDIC alleges that Western's financial statements should have shown that Western had a negative net worth of at least \$100,000,000 at the end of 1984 and a negative net worth of at least \$200,000,000 at the end of 1985, yet Arthur Young gave "clean," unqualified opinions on the 1984 and 1985 financial statements to both Western's directors and to the FSLIC.<sup>63</sup>

As more S&Ls were declared insolvent, questions began to be raised about the auditors' methods, and allegations of accountant impropriety continued to surface. For example, in a shareholder's suit against Charles Keating, a memo surfaced which allegedly was circulated among the partners at the accounting firm Touche & Ross which stated: "[A]ccountants will probably soon run out of ways under GAAP to postpone the recognition of losses in a business having long-term, low-earning assets and capitalized with short-term, high-cost obligations."<sup>64</sup>

Some S&Ls engaged in questionable hiring practices and became known for their "accountant shopping."<sup>65</sup> Charles Keating's Lincoln Savings and Loan, for example, hired four accounting firms in five years, prompting some to accuse Lincoln of shopping for auditors to get the "treatment" it wanted.<sup>66</sup> It was also disclosed that in some situations, once independent accountants had audited the S&L, those same accountants were then hired by the S&L after issuing favorable audit opinions. For example, in the Lincoln Savings and Loan case, it was revealed that Jack Atchison, a lead auditor with Arthur Young, allegedly wrote letters to several senators discouraging regulatory take-over of Lincoln, and that one month after Atchison signed Arthur Young's "clean audit," he was hired by Charles Keating at four times his former salary (from a previous salary of \$225,000 a year to over \$900,000 a year).<sup>67</sup> Astonishingly, it was also reported that Charles

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63. Complaint of FDIC at 27, FDIC v. Ernst & Young and Arthur Young & Company, No. CA3-90-0490-H, (N.D. Tex. filed Mar. 1, 1990) [hereinafter Complaint, FDIC v. Ernst & Young]. This suit seeks \$560 million in damages from the Big Six accounting firm, Ernst & Young. *Id.* It is the largest suit ever brought against an accounting firm. Waldman, *The Other S&L Culprits*, TIME, Oct. 29, 1990, at 54. See also Wayne, *supra* note 9.

64. Moore, *Cash Call*, 22 NAT'L J. 2244 (1990).

65. CPA Hearing, *supra* note 22, at 22. See also McTague, *Accountants Shy of Weak Thrifts in Lincoln Wake*, AM. BANKER, Dec. 22, 1989, at 11. William Black of the Office of Thrift Supervision testified that "[i]n the trade, it was called 'accountant shopping,' and the K Mart blue light special among accountants was Arthur Young's Dallas office." *Id.*

66. CPA Hearing, *supra* note 22, at 22.

67. Lavin, *supra* note 41, at 9. Atchison wrote letters to several Senators on March 17, 1987, stating that Lincoln was a "strong and viable financial entity" and suggesting that federal thrift regulators were harassing Lincoln. Parloff, *The Banking Crisis: Wheel*

Keating and his son admitted that Atchison was only one of approximately fifty accountants who had worked on independent audits of Lincoln Savings and Loan and later had been hired by Lincoln and its affiliates.<sup>68</sup>

Another example of possible auditor misconduct was exposed when Crescent Federal Savings & Loan Association dismissed the accounting firm of J.K. Byrne and retained Price Waterhouse & Co. to audit the S&L. During its examinations, Price Waterhouse discovered over 1,000 accounting errors in Crescent's financial records that were not reported earlier.<sup>69</sup>

Thus, evidence of "clean" S&L audits shortly before insolvency, balance sheet manipulations, questionable accountant hiring practices, and substantial accounting errors resulted in a call for congressional inquiry into the role of accountants in the emerging S&L crisis.

### III. THE CONGRESSIONAL RESPONSE TO ACCOUNTANTS' LIABILITY IN THE SAVINGS AND LOAN CRISIS

#### A. *The GAO Report*

Prompted by the number of failures in the thrift industry and the failure of independent accountants' audits to reveal the extent of those financial problems, the House Committee on Banking, Finance and Urban Affairs requested that the United States General Accounting Office (GAO) review the quality of S&L audits in the Dallas Federal Home Loan Bank District.<sup>70</sup> The GAO's study focused on eleven of the twenty-nine S&Ls that had failed in the district between January 1, 1985 and September

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of *Fortune*, AM. LAW., Mar. 1991, at 60, 64 (1991). See also *CPA Hearing*, *supra* note 22, at 67; Chadwick, *Big Suits*, AM. LAW., Sept. 1991, at 38, 39; McCoy, Schmitt, & Bailey, *Hall of Shame: Besides S&L Owners, Host of Professionals Paved Way for Crisis*, Wall Street J., Nov. 2, 1990, at A9, col. 5.

68. Lavin, *supra* note 41, at 9 ("Atchison was only one of many accountants on the staff. At one time, Keating bragged that he hired 50 away from his auditors. Regulators have noted that that was one way to ensure a friendly audit."). See also Williamson, *Keating's Influence in High Places*, San Francisco Chronicle, Nov. 20, 1989, at A4.

69. Complaint, FDIC v. Schoenberger, *supra* note 26, at 21. It is interesting to note, however, that Price Waterhouse has not escaped criticism for its audits of financial institutions. Price Waterhouse has been criticized for its reports issued for the Bank of Credit and Commerce International (BCCI). Sly, *Tales of Massive Deceit Emerge in BCLI Scandal*, N.Y. Times, Aug. 18, 1991, § C, at 1, col. 1 ("A 1990 investigation by Price Waterhouse into the shaky state of BCCI's balance sheet catalogs loan after loan made with virtually no documentation. . . . Even after the 1990 report, Price Waterhouse certified BCCI's accounts as fair and accurate.").

70. UNITED STATES GENERAL ACCOUNTING OFFICE, CPA AUDIT QUALITY: FAILURES OF CPA AUDITS TO IDENTIFY AND REPORT SIGNIFICANT SAVINGS AND LOAN PROBLEMS 2 (1989) [hereinafter GAO REPORT] (Pub. No. AFMD-89-45).

30, 1987.<sup>71</sup> In February 1989, the GAO issued a report finding that in six of the eleven S&L audits it examined, the independent certified public accountants did not "adequately audit and/or report the S&Ls' financial or internal control problems in accordance with professional standards."<sup>72</sup> The study found that accountants did not adequately report significant problems such as: (1) S&L accounting practices which were not in conformity with standard accounting principles; (2) regulatory violations (*i.e.*, excessive loans to related parties or single borrowers); (3) formal regulatory actions; (4) concentrations of high-risk loans within restricted geographic areas; and (5) serious internal control weaknesses.<sup>73</sup>

The GAO report stated that accurate CPA audits of S&Ls were vitally necessary to enable federal officials to regulate the S&L industry effectively and that significant improvements were needed in the quality of S&L audits.<sup>74</sup> The report recommended that the American Institute of Certified Public Accountants (AICPA) revise its 1979 audit guide for S&Ls, inform its members of the contents of the GAO report, and instruct them on the particular problems that might occur when auditing S&Ls.<sup>75</sup> After conducting its study and finding significant audit and reporting problems in six of the eleven S&Ls studied, the officials at the GAO referred the CPA firms performing the audits to the appropriate regulatory and professional bodies for disciplinary action.<sup>76</sup>

#### *B. Hearing Before the House Committee on Banking, Finance and Urban Affairs*

In response to the GAO Report, the House Committee on Banking, Finance and Urban Affairs conducted a hearing on February 21, 1989, in which prominent members in the accounting field testified and responded to the critical GAO Report.<sup>77</sup> The representatives from the accounting field asserted that the GAO Report was misleading because only six of twenty-nine S&L audits in the Dallas district were criticized

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71. *Id.* at 1. See also Kheel & Sohmer, *The GAO's Report to the House Banking, Finance and Urban Affairs Committee: CPA Audit Quality*, 653 PRAC. L. INST. 113 (1989); Kolins, *Accounting & Auditing Report*, 22 PRAC. ACCT. 102 (1989).

72. GAO REPORT, *supra* note 70, at 1. The GAO report found that, before the 11 S&Ls failed, their latest audit reports showed a combined positive net worth of \$44 million, yet 5 to 17 months later when the S&Ls failed, the 11 S&Ls had a combined negative net worth of \$1.5 billion. *Id.*

73. *Id.* at 5.

74. *Id.* at 10.

75. *Id.* at 10-11.

76. *Id.* at 1.

77. CPA HEARING, *supra* note 22, at 1.

and that twenty-seven of twenty-nine audit reports included qualifications.<sup>78</sup>

The accounting representatives and several congressional participants cited numerous other causes of S&L insolvencies and inaccurate S&L audits. They noted the following causes: (1) fraud by S&L management (arguing CPAs could conduct an audit according to GAAP and still be victims of fraud);<sup>79</sup> (2) faulty examinations by federal regulators and regulators' failure to quickly close insolvent thrifts;<sup>80</sup> (3) ambiguous accounting standards (both AICPA and federal regulators' standards);<sup>81</sup> (4) inherent limitations of the audit process (arguing accountants could not look at every transaction because they must contain the costs of the audit);<sup>82</sup> (5) federal and state deregulation (extended in some states and unaccompanied by increased oversight);<sup>83</sup> (6) faulty appraisals (upon which audit opinions were based);<sup>84</sup> and (7) congressional authorization of deviations from GAAP despite warnings from the AICPA to Congress not to weaken accounting standards during deregulation.<sup>85</sup> In fact, Mr. Philip Chenok, President of the AICPA, testified as follows:

The profession has done a great deal over the years to warn about those activities which weakened the S&L accounting disciplines. . . .

As far back as 1981, when the Federal Home Loan Bank Board allowed savings and loan associations to defer losses from the sale of assets with below-market yields, the profession warned that such treatment was inconsistent with generally accepted accounting principles.

In 1982, when Congress passed the Garn-St Germain Depository Institutions Act, which allowed qualifying subordinated

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78. *Id.* at 23-24. Members of the accounting profession have also criticized the GAO Report for its limited time frame and scope. They argue that the S&L selection process predetermined the report's outcome (because of the eleven audits studied, nine were selected due to their "clean opinions"), and that the subsequent "6 of 11" or "more than half" statistic is therefore misleading. See Goldwasser, *supra* note 9, at 24-25.

79. *CPA Hearing, supra* note 22, at 28.

80. *Id.* at 5, 21, 65. Accountants offered as an example the fact that in 1986, Arthur Young made a heavily qualified audit report of Western Savings and Loan, but federal regulators did not close Western until May 1987, a year later. *Id.* at 65.

81. *Id.* at 25.

82. *Id.* at 5.

83. *Id.* at 28, 30, 31, 65.

84. *Id.* at 34-35.

85. *Id.* at 15. See also *Statement of Philip B. Chenok, President, American Institute of Certified Public Accountants Before the Committee on Banking, Finance and Urban Affairs, United States House of Representatives*, 167 J. ACCT. 143, 144 (1989); *Warnings Unheeded in S&L Crisis, Says AICPA in Testimony*, 167 J. ACCT. 15 (1989).

debentures, appraised equity capital and net worth certificates to be included in net worth for regulatory purposes, it was warned that such differences between regulatory accounting principles and generally accepted accounting principles could lead to confusion and misleading financial reports.

When regulators appeared to be allowing excessive up-front income recognition for loan origination and commitment fees, the profession warned against inconsistency with generally accepted accounting principles.

Again, when proposals to permit the deferral and amortization of loan losses in a manner inconsistent with sound accounting procedure emerged, the profession warned against such actions.

As recently as last year, when the Federal Home Loan Bank Board sought to have withdrawn AICPA guidance requiring disclosure of certain loss possibilities in FSLIC assisted mergers, the profession held firm.<sup>86</sup>

The AICPA President submitted an extensive list which documented AICPA's professional education programs and summarized the organization's pronouncements, comment letters, and congressional testimony.<sup>87</sup>

### *C. FIRREA: The Financial Institutions Reform, Recovery and Enforcement Act of 1989*

After numerous congressional hearings on the S&L crisis, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).<sup>88</sup> FIRREA completely reorganized the supervisory structures of thrift institutions<sup>89</sup> and restricted the investment activities of thrifts.<sup>90</sup> The law also abolished the FSLIC<sup>91</sup> and gave the FDIC the responsibility of insuring both S&L and bank deposits.<sup>92</sup>

FIRREA's most important impact on accountants is that it increased the enforcement authority of banking agencies.<sup>93</sup> Under FIRREA, an

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86. *CPA Hearing*, *supra* note 22, at 16-17.

87. *Id.* at 115-45.

88. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183 (codified at scattered sections of 12 and 15 U.S.C.). See also Gail & Norton, *supra* note 15, at 1106.

89. Gail & Norton, *supra* note 15, at 1108.

90. *Id.* at 1153-87.

91. 12 U.S.C. § 1821a (Supp. I 1989). See also Gail & Norton, *supra* note 15, at 1109.

92. 12 U.S.C. § 1814(a) (Supp. I 1989). See also Gail & Norton, *supra* note 15, at 1108.

93. Gail & Norton, *supra* note 15, at 1188. See also Clark, Murtagh, & Corcoran,

independent accountant is considered an "institution-affiliated party" if the accountant "knowingly or recklessly participates in (a) any violation of law or regulation; (b) any breach of fiduciary duty; or (c) any unsafe or unsound practice, which caused or is likely to cause more than a minimal financial loss to, or a significant adverse effect on, the insured depository institution."<sup>94</sup> Under expanded civil and criminal penalties, as an institution affiliated party, an accountant could be fined up to one million dollars per day for FIRREA violations.<sup>95</sup>

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*supra* note 1, at 1028. See generally Malloy, *Nothing to Fear But FIRREA Itself: Revising and Reshaping the Enforcement Process of Federal Bank Regulation*, 50 OHIO ST. L.J. 1117 (1989); *Enforcement Provisions of Financial Institutions Reform, Recovery and Enforcement Act of 1989*, 36 FED. B. NEWS J. 481 (1989); Comment, *Civil Money Penalties in the Financial Institutions Reform, Recovery and Enforcement Act of 1989*, 12 GEO. MASON U.L. REV. 289 (1990).

94. 12 U.S.C. § 1813(u) (Supp. I 1989). See also Gail & Norton, *supra* note 15, at 1188. The "knowing" and "reckless" standards of conduct have been defined in criminal law and tort law. See, e.g., MODEL PENAL CODE § 2.02 (Official Draft 1985) which states:

(b) Knowingly.

A person acts knowingly with respect to a material element of an offense when:

(i) if the element involves the nature of [her] conduct or the attendant circumstances, she is aware that [her] conduct is of that nature that such circumstances exist; and

(ii) if the element involves a result of [her] conduct, she is aware that it is practically certain that [her] conduct will cause such a result.

(c) Recklessly.

A person acts recklessly with respect to a material element of an offense when he consciously disregards a substantial and unjustifiable risk that the material element exists or will result from his conduct. The risk must be of such nature and degree that, considering the nature and purpose of the actor's conduct and the circumstances known to him, its disregard involves gross deviation from the standard of conduct that a law-abiding person would observe in the actor's situation.

See also W. KEETON, D. DOBBS, R. KEETON, & D. OWEN, *PROSSER AND KEETON ON THE LAW OF TORTS* 213 (5th ed. 1984) [hereinafter PROSSER AND KEETON] (footnotes omitted).

The usual meaning assigned to . . . "reckless" . . . is that the actor has intentionally done an act of an unreasonable character in disregard of a known or obvious risk that was so great as to make it highly probable that harm would follow, and which thus is usually accompanied by a conscious indifference to the consequences.

*Id.* See also Kawasaki, *Liability of Attorneys, Accountants, Appraisers, and Other Independent Contractors Under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989*, 42 HASTINGS L.J. 249, 274 (1990).

95. 12 U.S.C. § 1818(i)(2) (1988 & Supp. I 1989). As "institution-affiliated parties," accountants could be fined the following civil money penalties:

(a) Tier One: An accountant may be fined up to \$5,000 per day for violations of any law, regulation, final regulatory agency order, condition or written condition or agreement with regulatory agencies. 12 U.S.C. § 1818(i)(2)(A)

FIRREA also authorizes federal regulators to take action against affiliated parties (such as accountants) even before the S&L fails,<sup>96</sup> to issue a cease-and-desist order to terminate an affiliated party's contract with the savings and loan,<sup>97</sup> and to issue an industry-wide prohibition against an accounting firm or an individual accountant.<sup>98</sup> Finally, FIRREA sets a six-year statute of limitations for commencement of civil and criminal actions from the time an accountant ceases to be affiliated with the institution.<sup>99</sup>

Thus, through its GAO Report, congressional hearing, and statutory enforcement provisions, Congress has responded in some measure to the allegations of S&L accountant impropriety. However, the courts have not yet made their determinations as suits against accounting firms for S&L audits have only been recently filed. The sequence of events which led to hundreds of S&L insolvencies, the differing expectations of an auditor's role, the evidence of possible auditor misconduct in S&L audits, and the congressional responses to the S&L audit issue have set the stage for present and future litigation of the issue of accountants' liability in the S&L crisis.

#### IV. CLAIMS AGAINST ACCOUNTANTS FOR THEIR AUDITS OF FAILED S&Ls

##### A. *Parties Who May Assert Claims Against Accountants*

Once a savings and loan institution has been declared insolvent (or

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(Supp. I 1989).

- (b) Tier Two: An accountant may be fined up to \$25,000 per day for any tier one violations, for reckless engagement in an unsafe or unsound practice in conducting the affairs of the institution, or for a breach of a fiduciary duty. The violation must involve a pattern of misconduct resulting in personal gain and cause more than minimal loss to the financial institution. *Id.* § 1818(i)(2)(B).
- (c) Tier Three: An accountant may be fined up to \$1,000,000 per day if the accountant knowingly or recklessly causes substantial loss to a financial institution or receives substantial personal gain as a result of her or his activity. *Id.* § 1818(1)(2)(C), (D).

Under FIRREA's criminal penalties, an accountant could also be fined up to \$1,000,000, imprisoned for up to five years, or both if convicted for knowingly participating in a financial institution's affairs while subject to an order. *Id.* § 1818(j). See also Gail & Norton, *supra* note 15, at 1193; Kawasaki, *supra* note 94, at 263-64; Murphy, *Claims Against Accountants, Attorneys, and Appraisers, FAILING FINANCIAL INSTITUTIONS: A.L.I. - A.B.A. COURSE OF STUDY MATERIALS*, 101, 104-05 (Oct. 11-12, 1990).

96. 12 U.S.C. § 1818(b) (1988 & Supp. I 1989). See also Hirschberg & Univer, *Accountants' Liability in Connection with Failed Financial Institutions, FAILING FINANCIAL INSTITUTIONS: A.L.I. - A.B.A. COURSE OF STUDY MATERIALS*, 119, 130 (Oct. 11-12, 1990).

97. 12 U.S.C. § 1818(b) (1988 & Supp. I 1989). See also Hirschberg & Univer, *supra* note 96, at 130.

98. 12 U.S.C. § 1818(e)(7) (1988 & Supp. I 1989). See also Hirschberg & Univer, *supra* note 96, at 130.

99. 12 U.S.C. § 1818(i)(3) (1988 & Supp. I 1989). See also Hirschberg & Univer, *supra* note 96, at 130.

is in danger of insolvency), the Federal Deposit Insurance Corporation (FDIC) or the Resolution Trust Corporation (RTC) has authority to take over the institution as either a receiver or a conservator of the failed S&L.<sup>100</sup> As receiver or conservator, the FDIC or RTC succeeds to "all rights, titles, powers, and privileges" of the S&L<sup>101</sup> and thereby legally "stands in the shoes" of the S&L.<sup>102</sup> Because the S&L could have sued the accountants based upon the parties' prior contractual relationship,<sup>103</sup> the FDIC, now "standing in the shoes" of the S&L, may also bring a direct claim against the S&L auditors.<sup>104</sup> The FDIC may also assert a claim against the S&L's auditors in its corporate capacity as assignee of claims owned by the S&L.<sup>105</sup>

As the primary party in suits against accounting firms, the FDIC is currently pursuing lawsuits against accounting firms for their audits of S&Ls, but none of these cases has yet proceeded to trial.<sup>106</sup> Presently, the FDIC and the RTC have eighteen lawsuits pending against accounting

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100. 12 U.S.C. § 1821(c) (1988 & Supp. I 1989). See also Gail & Norton, *supra* note 15, at 1132. In distinguishing between a conservator and a receiver,

[a] conservator is appointed to operate or dispose of the association as a going concern and is specifically empowered to take any necessary steps to put the association in a sound and solvent condition, to carry on the business of the association, and to preserve and conserve the assets and property of the association. A receiver is appointed to liquidate the assets and to resolve the affairs of a failed savings association.

Tucker, Meire, & Rubinstein, *The RTC: A Practical Guide to the Receivership/Conservatorship Process and the Resolution of Failed Thrifts*, 25 U. RICH. L. REV. 1, 24 (1990). In determining whether the RTC or the FDIC is appointed as receiver or conservator, [t]he OTS [Office of Thrift Supervision] must appoint the RTC as receiver in the case of any savings association whose deposits were insured by the FSLIC prior to enactment of FIRREA and for which a receiver or conservator had been or is appointed during the period beginning January 1, 1989 and August 9, 1992. The FDIC must be appointed the receiver by the OTS in all other cases. Either the FDIC or the RTC may serve as conservator for a federal or state savings association.

*Id.* at 10. See also 12 U.S.C. § 1464(d)(2)(H)(ii) (Supp. I 1989).

101. 12 U.S.C. § 1821(d)(2)(A)(i) (1988 & Supp. I 1989). See also Gail & Norton, *supra* note 15, at 1135; Tucker, Meire, & Rubinstein, *supra* note 100, at 24.

102. Tucker & Eisenhofer, *Accountants' Liability: Negligent Representation Suits Multiply in Wake of S&L Crisis*, NAT'L L.J., June 25, 1990, at 18. See also Dilloff, *Banking Reform Act Advances: Thrifts Crisis*, NAT'L L.J., Sept. 4, 1989, at 15.

103. See *Ultramaras Corp. v. Touche*, 255 N.Y. 170, 174 N.E. 441 (1931).

104. Gail & Norton, *supra* note 15, at 1135; Tucker & Eisenhofer, *supra* note 102, at 18.

105. Hirschberg & Univer, *supra* note 96, at 122-23.

106. Telephone interviews with Anne Buxton Sobol, former Assistant General Counsel of the Federal Deposit Insurance Corporation (Oct. 18, 1990, Nov. 2, 1990, Nov. 15, 1990, Nov. 20, 1990, Aug. 22, 1991, Oct. 6-7, 1991).

firms for the firms' audits of S&Ls.<sup>107</sup> In addition to these eighteen pending suits, the FDIC and RTC have settled an additional eleven lawsuits totalling more than forty million dollars.<sup>108</sup> As revealed in Appendix A and the list of the settled lawsuits below, the FDIC and RTC have filed suit against all of the "Big Six" accounting firms except Price Waterhouse & Co. for audits of now-failed S&Ls.<sup>109</sup>

It is likely that many of the FDIC's pending accountant suits will be settled out of court because accounting firms want to avoid the negative publicity of prolonged lawsuits as well as possible adverse court opinions that would seriously damage the public trust inherent in the auditing process.<sup>110</sup> Further, the FDIC is also motivated to settle its S&L

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107. *Id.* See Appendix A for pending FDIC and RTC suits against accounting firms for audits of failed S&Ls.

108. *Id.* Telephone interviews with J.P. Monahan, Federal Deposit Insurance Corporation Legal Division, Professional Liabilities Section, Washington, D.C. (Aug. 22, 1991, Sept. 28, 1991). As of October 7, 1991, the FDIC has settled the following suits against accounting firms for the firms' audits of failed S&Ls:

- (a) *FSLIC v. Greenstein Logan & Co.* (for audit of Ben Milam S&L in Cameron, Texas and Mercury Savings Association in Witchita Falls, Texas; settled for \$400,000);
- (b) *FSLIC v. McGladrey Hendrickson* (for audit of San Marino S&L in San Marino, California; settlement undisclosed);
- (c) *FSLIC v. Coopers & Lybrand* (for audit of First Federal S&L in Niles, Michigan; settlement undisclosed);
- (d) *FSLIC v. Laventhal Horwath* (for audit of Pittston S&L in Pennsylvania; settlement undisclosed);
- (e) *FSLIC v. Warner Phillips* (for audit of State Federal S&L Assoc. in Corvallis, Oregon; settlement undisclosed);
- (f) *FSLIC v. Regier, Carr Monroe* (for audit of Oklahoma Federal S&L in El Reno, Oklahoma; settled for \$1,500,000);
- (g) *FDIC v. Armbrister* (for audit of Mountain Security Savings Bank in Wytheville, Virginia; settled for \$1,440,452);
- (h) *FSLIC v. Anders* (for Peat Marwick's audit of Farmers Savings Bank in Davis, California; settled for \$11.3 million);
- (i) *FSLIC v. Fitzpatrick* (for Touche Ross's audit of Beverly Hills S&L in Mission Viejo, California; settlement undisclosed) (The FDIC and Touche Ross both agree that the case has been settled, but there is continuing litigation over the nonmonetary terms of the settlement).

As of September 26, 1991, the RTC has settled the following suits against accounting firms for the firms' audits of failed S&Ls: (a) *RTC v. Frost & Co.* (for audit of Madison Guaranty S&L in Augusta, Arkansas; settlement undisclosed) and (b) *RTC v. Regier, Carr & Monroe* (for audit of Great Plains S&L in Weatherford, Oklahoma; settlement undisclosed). Telephone interview with Felicia Neuringer, Resolution Trust Corporation, RTC Communications Director, Washington, D.C. (Sept. 26, 1991).

109. Rehm, *Suits Target Deep Pockets of Accountants*, AM. BANKER, Mar. 13, 1990, at 7, col. 1.

110. *Banking Reform Act Advances: Thrift Crisis*, NAT'L L.J., Sept. 4, 1989, at

accountant claims due to the fact that accountants' malpractice insurance policies are often "self-liquidating," thus requiring defense costs to be charged against the malpractice insurance policy limits.<sup>111</sup>

Besides the FDIC, other parties such as state regulatory agencies or state appointed receivers may assert direct claims against accounting firms for S&L audits.<sup>112</sup> For example, in *Maryland Deposit Insurance Fund Corporation v. Grant Thornton*,<sup>113</sup> Maryland savings and loan authorities sued an insolvent thrift's accountants for their alleged inadequate financial reporting (although the case was settled without determining the validity of the claim).<sup>114</sup>

Nonclient third parties who claim to have suffered financial losses due to their reliance upon S&L auditors' reports may also have standing to bring claims against accounting firms for the accountants' S&L audits.<sup>115</sup> Potential third party plaintiffs could be S&L depositors,<sup>116</sup> S&L creditors,<sup>117</sup> S&L shareholders or investors,<sup>118</sup> purchasers of S&L loans and certificates of deposit,<sup>119</sup> parties who made loans to S&L purchasers

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15. See also Rozen, *Gladiator Among the Green Eyeshades*, AM. LAW., May 1991, at 40. However, if these suits are not settled, and a judgment is entered against an accounting firm, recent changes by accounting firms to reorganize as corporations instead of partnerships (to reduce liability) would not shield firms because an accounting firm's new corporate status would not be retroactive to the events in question in these suits. See Dawson, *Comptroller Wants Tougher Laws for Accountants*, REUTER BUS. REP., Aug. 2, 1990; Cowan, *C.P.A.'s to Sell Stock in Practice*, N.Y. Times, June 14, 1990, at 1, col. 3. Also, if liable, accounting firms will have to pay damages from their insurance coverage, but such coverage is significantly less than many of the damages alleged in the suits against accounting firms. See Schachner, *S&L Litigation Won't Ruin Accountant E&O Market*, Bus. Ins., March 20, 1989 at 2 (It is estimated that the largest accounting firms purchase only \$50 million to \$100 million in professional liability coverage worldwide.).

111. Sontag, *Soured Deals Snag More Professionals: Lawyers, Accountants and Others Often Are the Only Deep Pockets*, NAT'L L.J., Feb. 4, 1991, at 1.

112. Hirschberg & Univer, *supra* note 96, at 123.

113. No. 87062047-CL62242 (Baltimore Cir. Ct. 1985).

114. *Id. See also* Hirschberg & Univer, *supra* note 96, at 123.

115. Hirschberg & Univer, *supra* note 96, at 123-24. See also Tucker & Eisenhofer, *supra* note 102, at 17.

116. E.g., Popkin v. Jacoby, No. 88-1713 (E.D. Pa. 1989) (class action brought by depositors at Sunrise Savings and Loan Association against S&L directors and officers and against accounting firm Deloitte, Haskins & Sells).

117. E.g., Colonial Bank of Ala. v. Ridley & Schweigert, 551 So. 2d 390 (Ala. 1989).

118. E.g., Blake v. Dierdorff, 856 F.2d 1365 (9th Cir. 1988); Bedevian v. Ernst & Whinney, No. 89 CIV 6541 (RJW) (S.D.N.Y. 1989).

119. E.g., E.F. Hutton Mortgage Corp. v. Pappas, 690 F. Supp. 1465 (D. Md. 1988) (purchaser of loans); Brockton Sav. Bank v. Peat, Marwick, Mitchell & Co., 577 F. Supp. 1281 (D. Mass. 1983) (purchaser of certificates of deposit).

that later became insolvent,<sup>120</sup> and even accountants who sue their predecessor auditors.<sup>121</sup>

Currently, jurisdictions have adopted three different approaches to determining whether a nonclient third party has standing to sue an auditor for negligence.<sup>122</sup> The three basic approaches — established by the strict privity rule, the Restatement rule, and the liberal foreseeability rule — differ essentially as to the number of potential plaintiffs that may bring suit against the accounting firm.<sup>123</sup> Thus, the ability of a third party to bring a claim against an accounting firm for S&L audits is therefore determined by the status of accountants' liability law in that jurisdiction.

In jurisdictions following the traditional privity rule of *Ultramare Corp. v. Touche*,<sup>124</sup> accountants are liable only to parties with whom they are in privity of contract.<sup>125</sup> Therefore, under the strict privity rule, a third party does not have standing to sue an accountant because the contract was between the auditor and the institution, not the auditor and the third party.<sup>126</sup> Interestingly, the New York Court of Appeals recently modified the strict privity rule in *Credit Alliance Corp. v. Arthur Andersen & Co.*<sup>127</sup> and held that accountants are liable to parties with whom they are in privity, and to those in a relationship "sufficiently

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120. E.g., *Idaho Bank & Trust Co. v. First Bancorp of Idaho*, 115 Idaho 1082, 772 P.2d 720 (1989).

121. See *Hirschberg & Univer*, *supra* note 96, at 130.

122. Tucker & Eisenhofer, *supra* note 102, at 17. See generally Bagby & Ruhnka, *supra* note 7, at 149; Elliott, *Expanding Third Party Liability for Accountants: Finding a Middle Ground: Blue Bell v. Peat, Marwick, Mitchell & Co.*, 19 TEX. TECH L. REV. 171 (1988); Hawkins, *Professional Negligence Liability of Public Accountants*, 12 VAND. L. REV. 797 (1959); Marinelli, *Accountants' Liability to Third Parties*, 16 OHIO. N.U.L. REV. 1 (1989); Millian, *An Accountant's Liability to Third Parties: A Continued Assault on the Citadel of Privity*, 19 Stetson L. Rev. 711 (1990); Brodsky, *Accountant Liability to Non-Clients*, N.Y.L.J. Dec. 18, 1990, at 3; Cooper, *Accountants' Liability: Privity Rule Is Necessary in Today's Marketplace*, N.Y.L.J., Apr. 9, 1990, at 1; Annotation, *Liability of Public Accountants to Third Parties*, 46 A.L.R.3RD 979 (1985).

123. Tucker & Eisenhofer, *supra* note 102, at 18.

124. 255 N.Y. 170, 174 N.E.2d 441 (1931).

125. *Id.*

126. *Id.* See also *Koch Indus. v. Vosko*, 494 F.2d 713 (10th Cir. 1974); *Stephens Indus. v. Haskins & Sells*, 438 F.2d 357 (10th Cir. 1971); *Hartford Accident & Indem. Co. v. Parente, Randolph, Orlando, Carey & Assoc.*, 642 F. Supp. 38 (M.D. Pa. 1985); *Safeco Ins. Co. of Am. v. Stockton Bates Co.*, No. 83-6207 (E.D. Pa. 1985); *Shofstall v. Allied Van Lines*, 455 F. Supp. 351 (N.D. Ill. 1978); *Canaveral Capital Corp. v. Bruce*, 214 So. 2d 505 (Fla. App. 1968); McDonald, *Accountants' Liability to Third Parties: Unmanageable Risks of Foreseeability*, 57 DEF. COUNS. J. 194, 195; Tucker & Eisenhofer, *supra* note 102, at 17.

127. 65 N.Y.2d 536, 483 N.E.2d 110, 493 N.Y.S.2d 435 (1985).

approaching privity" (the "near privity rule").<sup>128</sup> Although several states have codified some variation of the privity rule,<sup>129</sup> the trend is toward more expanded liability.<sup>130</sup>

In jurisdictions following the Restatement approach, courts have extended accountants' liability for negligence not only to those with whom the accountant is in contractual privity, but also to particular parties whom the accountant anticipated would receive and rely upon the audit report.<sup>131</sup> The Restatement (Second) of Torts states that an accountant is liable to:

- a) the person or one of a limited group of persons for whose benefit and guidance [the accountant] intends to supply the information or knows that the recipient intends to supply it; and
- b) through reliance upon it in a transaction that [the accountant] intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.<sup>132</sup>

Finally, a few jurisdictions have recently adopted a more liberal foreseeability rule which significantly expands an accountant's liability for an inadequate audit.<sup>133</sup> In a movement from contract law toward tort law, the foreseeability rule provides that accountants are potentially

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128. *Id.* See also *Toro Co. v. Krouse, Kern & Co.*, 827 F.2d 155, 161 (7th Cir. 1987) (accounting firm and individual accountants not liable for negligence to third party who relied on audit report unless accountant's conduct reveals accountant had actual knowledge that "the particular person or entity bringing the law suit would rely on the information given"); *Brodskey, supra* note 122, at 3.

129. ARK. STAT. ANN. § 16-114-302 (1987); ILL. REV. STAT. ch. 111, para. 5535.1 (1986); KAN. STAT. ANN. § 1-402 (1990).

130. *Marinelli, supra* note 122, at 9.

131. See, e.g., *Briggs v. Sterner*, 529 F. Supp. 1155 (S.D. Iowa 1981); *Ingram Indus. v. Nowicki*, 527 F. Supp. 683 (E.D. Ky. 1981); *Bonhiver v. Graff*, 248 N.W.2d 291 (Minn. 1976); *Aluma Kraft Mfg. Co. v. Elmer Fox & Co.*, 493 S.W.2d 378 (Mo. Ct. App. 1973); *Spherex Inc. v. Alexander Grant & Co.*, 122 N.H. 898, 451 A.2d 1308 (1982); *Haddon View Inv. Co. v. Coopers & Lybrand*, 70 Ohio St. 2d 154, 436 N.E.2d 212 (1982); *Shatterproof Glass Corp. v. James*, 466 S.W.2d 873 (Tex. Civ. App. 1971). See also *Gossman, IMC v. Butler: A Case for Expanded Professional Liability for Negligent Misrepresentation?*, 26 Am. Bus. L.J. 99, 103 (1988); *Hirschberg & Univer, supra* note 96, at 131.

132. RESTATEMENT (SECOND) OF TORTS § 552 (1977). See also *Marinelli, supra* note 122, at 5.

133. E.g., *International Mortgage Co. v. John P. Butler Accountancy Corp.*, 177 Cal. App. 3d 806, 223 Cal. Rptr. 218 (1986); *Touche Ross & Co. v. Commercial Union Ins. Co.*, 514 So. 2d 315 (Miss. 1987); *H. Rosenblum, Inc. v. Adler*, 93 N.J. 324, 461 A.2d 138 (1983); *Citizens State Bank v. Timm, Schmidt & Co.*, 113 Wis. 2d 376, 335 N.W.2d 361 (1983). See also *Hirschberg & Univer, supra* note 96, at 125; *Gossman, supra* note 132, at 99.

liable to "all persons injured by reliance on a negligent audit report, so long as their reliance was reasonably foreseeable."<sup>134</sup>

Because few states still adhere to a strict or modified privity rule<sup>135</sup> and only a minority of states have adopted the foreseeability rule,<sup>136</sup> most third party suits brought against accountants will be governed by the moderate Restatement approach. Therefore, most third parties would have standing to sue an accounting firm for the firm's audits of an S&L if the third parties were part of a limited group whom the accountants intended to receive and rely on the report.<sup>137</sup>

Considering that the law on accountants' liability to third parties varies dramatically from state to state, the choice of law decision will often be crucial to the outcome of these third party suits.<sup>138</sup> Interestingly, the issue of which state's law should be applied in accountants' liability cases involving nationwide accounting firms has not often been litigated.<sup>139</sup> Therefore, it is likely that conflict of law questions will receive more attention in accountants' liability cases in the future.<sup>140</sup>

### B. Causes of Action Against Accountants for S&L Audits

Parties bringing suits against accountants for S&L audits have proceeded upon the following legal theories: (1) negligence and professional negligence (malpractice);<sup>141</sup> (2) negligent misrepresentation;<sup>142</sup> (3) breach of written and oral contracts and breach of implied covenants;<sup>143</sup> (4) federal and state regulatory violations;<sup>144</sup> (5) deceit or fraud;<sup>145</sup> (6) failure

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134. Gossman, *supra* note 132, at 104.

135. Tucker & Eisenhofer, *supra* note 102, at 17.

136. *Id.*

137. See RESTATEMENT (SECOND) OF TORTS § 552 (1977).

138. Swanson, *Accountants' Liability — Recent Developments, ACCOUNTANTS' LIABILITY: A.L.I. - A.B.A. COURSE OF STUDY MATERIALS* 379, 384 (Jan. 31 - Feb. 1, 1991).

139. *Id.*

140. *Id.*

141. E.g., Complaint of Plaintiff at 54, FDIC v. Deloitte & Touche and Deloitte, Haskins & Sells, No. LR-C-90-520, (E.D. Ark. filed July 25, 1990) (pending \$480 million suit against accounting firm Deloitte & Touche and former partnership Deloitte, Haskins & Sells for its audits of FirstSouth in Pine Bluff, Arkansas); Complaint, FDIC v. Ernst & Young, *supra* note 63, at 30; Complaint, FSLIC v. Jacoby, *supra* note 37, at 123.

142. E.g., Complaint of Plaintiff at 16, FSLIC v. Jeffery, Palazzola & Co., No. 88-01242 (C.D. Cal. filed Mar. 8, 1988) [hereinafter Complaint, FSLIC v. Jeffery, Palazzola & Co.] (former suit against accounting firm Jeffery, Palazzola & Co. for its audits of North America Savings and Loan Association in Santa Ana, California).

143. E.g., Complaint, FDIC v. Schoenberger, *supra* note 26, at 70; Complaint, FSLIC v. Fitzpatrick, *supra* note 36, at 38.

144. E.g., Complaint, FSLIC v. Jeffery, Palazzola & Co., *supra* note 142, at 13.

145. *Id.* at 15; Complaint of Plaintiff at 18, FSLIC v. Buceta, No. 86-3445 ER (C.D. Cal. filed May 29, 1986) [hereinafter Complaint, FSLIC v. Buceta] (former suit against firm Anderson, Alford & Ritter for its audits of State Savings and Loan Association in Salt Lake City, Utah).

to disclose or correct audits;<sup>146</sup> (7) violation of Rule 10b-5 securities laws;<sup>147</sup> and (8) violations of the Racketeer Influenced and Corrupt Organizations Act (RICO).<sup>148</sup> In spite of the various causes of action available in accountants' liability cases, plaintiffs' preferred cause of action is common-law negligence.<sup>149</sup>

### C. FDIC's Negligence Claim Against S&L Auditors

Given the FDIC's position as the most prominent plaintiff in lawsuits for thrift audit failure due to its multi-million dollar suits against accounting firms,<sup>150</sup> this section focuses on the *FDIC's* suits against accounting firms for the accountants' audits of failed S&Ls. Specifically, this section will analyze an FDIC negligence claim against accountants by examining the issues involved, exploring parties' arguments, and predicting the manner in which these issues might be resolved.<sup>151</sup>

1. *Duty and Standard of Care.*—In the FDIC's negligence action against an accounting firm for its audits of an S&L, the FDIC must establish the elements of negligence by first demonstrating that the accounting firm owed a duty of care in conducting its audits of the S&L.<sup>152</sup> In determining the proper standard of care required by ac-

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146. E.g., Complaint of Plaintiff at 12, FSLIC v. Regier Carr & Monroe, No. 88-C-1437B (N.D. Okla. filed Oct. 17, 1988) (settled suit against accounting firm Regier Carr & Monroe for its audits of Oklahoma Federal Bank in El Reno, Okla.).

147. E.g., DiLeo v. Ernst & Young, 901 F.2d 624 (7th Cir. 1990) (class of investors' suit against accounting firm Ernst & Young for audits of Continental Illinois Bank). See also Brodsky, *Accountants' Liability in the Savings and Loan Crisis*, N.Y.L.J., Aug. 1, 1990, at 3.

148. E.g., Complaint, FSLIC v. Buceta, *supra* note 145, at 25.

149. Hendricks, *Pleadings and Discovery Devices*, ACCOUNTANTS' LIABILITY: A.L.I.- A.B.A. COURSE OF STUDY MATERIALS 191, 193 (Jan. 31 - Feb. 1, 1991); Kiernan, *Defending an Accountant's Liability Suit*, ACCOUNTANTS' LIABILITY: A.L.I.- A.B.A. COURSE OF STUDY Materials 243, 249 (Jan. 31 - Feb. 1, 1991).

150. The FDIC has a separate professional liability section which is dedicated to pursuing claims against professionals such as accountants who provided services to seized thrifts and banks. This FDIC professional liability group is involved in investigations surrounding 1,000 financial institutions, and as a result of these investigations, the FDIC expects to collect more than \$370 million in settlements in 1990. Telephone interviews with Anne Buxton Sobol, former Assistant General Counsel of the Federal Deposit Insurance Corporation (Oct. 18, 1990, Nov. 2, 1990, Nov. 15, 1990, Nov. 20, 1990, Aug. 22, 1991, Oct. 6-7, 1991).

151. For this discussion, it will be assumed that the FDIC or RTC has brought suit against an accounting firm for the firm's S&L audits, but similar issues and arguments could be raised in suits brought by other plaintiffs against accounting firms for their S&L audits.

152. The plaintiff must establish the following traditional elements in a negligence suit:

countants, accountants may argue that the standard should be whether the accountants conducted their audit in conformity with GAAS and produced their opinion in conformity with GAAP.<sup>153</sup> However, in recent accountants' liability cases, courts have found that the duty of care required of accountants encompasses more than mere adherence to the GAAS and GAAP standards developed by AICPA.<sup>154</sup> Rather, courts have held that accountants have a duty to use reasonable professional care and that the GAAS and GAAP standards are merely evidence of reasonable professional care.<sup>155</sup> For example, in *Mishkin v. Peat, Marwick, Mitchell & Co.*,<sup>156</sup> the court defined the standard of care required of accountants as follows: "[An accountant] does undertake to use skill and due professional care and to exercise good faith and to observe

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- (1) duty — the defendant must have had a duty or obligation recognized by law "requiring the person to conform to a certain standard of conduct, for the protection of others against unreasonable risks";
  - (2) breach of duty — the defendant must have failed to conform to the standard required;
  - (3) causation — there must be a reasonably close causal connection between the defendant's conduct and the plaintiff's resulting injury;
  - (4) damage — the plaintiff (or the plaintiff's interests) must have experienced actual loss, damage, or injury.

See PROSSER AND KEETON, *supra* note 94, at § 30 (5th ed. 1984).

Negligence lawsuits brought against accountants have no different elements than the elements of the traditional common-law negligence action. See generally FDIC's Brief in Opposition to Defendant's Motion for Summary Judgment, FDIC v. Ernst & Young and Arthur Young and Company, No. CA3-90-0490-H (D.C. Tex. filed Mar. 29, 1991) [hereinafter FDIC's Brief in Opposition, FDIC v. Ernst & Young]. See also G. SPELMIRE, W. BALIGA, & D. WINLARSKI, ACCOUNTANT'S LEGAL LIABILITY GUIDE 10.03 (1990).

153. Eickemeyer, *Audit Issues in Litigation*, ACCOUNTANTS' LIABILITY: A.L.I. - A.B.A COURSE OF STUDY MATERIALS 89, 115 (Jan. 31 - Feb. 1, 1991); Hirschberg & Univer, *supra* note 96, at 122.

154. See *Bily v. Arthur Young & Co.*, 230 Cal. App. 3d 835, 271 Cal. Rptr. 470, superseded, 274 Cal. Rptr. 371, 798 P.2d 1214 (1990); *Maduff Mortgage Corp. v. Deloitte, Haskins & Sells*, 98 Or. App. 497, 779 P.2d 1083 (1989). See also Eickemeyer, *supra* note 153, at 110-16.

155. *Bily*, 230 Cal. App. 3d at 846, 271 Cal. Rptr. at 475 (1990) (accountant's obligation is to "use professional care" because GAAS and GAAP are not so comprehensive as to address every conceivable situation presented in an audit). In *Maduff Mortgage Corp. v. Deloitte, Haskins & Sells*, the Oregon appellate court discussed the role of GAAS and GAAP standards in determining the scope of an accountant's duty and stated:

The AICPA standards are only evidentiary. . . . [The standards] are principles and procedures developed by the accounting profession itself, not by the courts or the legislature. They may be useful to a jury in determining the standard of care for an auditor, but they are not controlling. The amount of care, skill and diligence to be used by defendant in conducting an audit is a question of fact for the jury, just as it is in other fields for other professionals.

*Maduff Mortgage Corp.*, 918 Or. App. at 502, 779 P.2d at 1086.

156. 744 F. Supp. 531 (S.D.N.Y. 1990).

generally accepted auditing standards and professional guidelines, with the appropriate reasonable, honest judgment that a reasonably skillful and prudent auditor would use under the same or similar circumstances.”<sup>157</sup> In the FDIC’s suits against accountants for their audits of S&Ls, the FDIC could most likely establish that the accountants had a duty to use reasonable professional care in their audits, using the GAAS and GAAP standards as evidence of reasonable professional care, but not as the sole yardstick by which the standard of care is measured.

2. *Breach of Duty*.—As for the breach of duty element, the FDIC would be required to demonstrate that S&L accountants failed to use reasonable professional care in their audits of the S&Ls. The FDIC could offer evidence of accountants’ failure to conform to GAAS and GAAP as well as evidence of specific circumstances in which the accountants failed to use reasonable professional care in planning, staffing, conducting, or reporting the S&L audits.<sup>158</sup>

3. *Causation*.—If the FDIC is able to establish the duty and breach of duty elements in a negligence action against accountants, the causation element would probably be the crucial element of the claim. The FDIC

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157. *Id.* at 538. See also FDIC’s Brief in Opposition, *FDIC v. Ernst & Young*, *supra* note 152, at 6 (“In its conduct of the audits, AY [Arthur Young] was obligated to exercise independent judgment and apply the level of care, diligence and prudence expected of professional accountants in the conduct of such audits.”); Kiernan, *supra* note 149, at 254.

158. E.g., Complaint, *FDIC v. Ernst & Young*, *supra* note 63, at 17-20. In *FDIC v. Ernst & Young and Arthur Young & Co.*, the FDIC’s Complaint alleges that Ernst & Young breached its duty and failed to plan and conduct their audits in accordance with GAAS because the accounting firm:

- (a) conducted inadequate evaluation of audit risks;
- (b) provided deficient technical training and proficiency of personnel;
- (c) lacked independent mental attitude;
- (d) failed to exercise due professional care in performance of audits;
- (e) violated standards of field work; and
- (f) failed to follow the Industry Guide.

*Id.* The FDIC alleges that “AY [Arthur Young], however, did not perform its audits in accordance with GAAS and did not exercise the due care required of it.” FDIC’s Brief in Opposition, *FDIC v. Ernst & Young*, *supra* note 152, at 6.

The FDIC’s Complaint also alleges that Ernst & Young breached its duty by improperly certifying Western Savings’ financial statements as consistent with GAAP when, in fact, the statements violated GAAP in the following respects:

- (a) improper recognition of profit from sales of real estate investments
- (b) improper recognition of profit from sales of real estate owned
- (c) improper recognition of income from net profit interests
- (d) failure to recognize losses as a result of troubled debt restructurings
- (e) inadequate provisions for loan and investment losses
- (f) inappropriate recognition of fee income
- (g) inappropriate recognition of interest income.

*Id.* at 20-26.

would have to show that the accountants' breach of their duty caused the S&L's losses (cause-in-fact).<sup>159</sup> To establish the causal connection between an accounting firm's audits and the S&L's losses, the FDIC could assert a "but for causation" argument: but for the accountants' faulty audits, the S&L would have suffered no losses because proper audits would have alerted S&L management and federal regulators to the thrift's insolvent condition.<sup>160</sup> Thus, the audits were *the cause* of the S&L's losses.<sup>161</sup> However, in cases of misconduct by S&L management, the FDIC could instead employ a "substantial factor" argument: that the accountants' flawed audits were a substantial factor in the S&L's losses. Thus, the audits were *one* of the causes of the S&L's losses.<sup>162</sup>

In either a "but for" or "substantial factor" causation argument, the FDIC could assert that the accountants' audits caused the S&Ls' losses due to one or more of the following facts: (1) had the auditors accurately audited the S&L, the Board of Directors (or at least a few of them) would have recognized that the S&L's loan programs were a failure and would have discontinued substandard lending practices;<sup>163</sup> (2) had the auditors correctly audited the S&Ls, regulations (such as the loan-to-one-borrower rule) would have limited the amount of loans that S&Ls could have made;<sup>164</sup> or (3) had the auditors correctly audited the S&L, regulators would have realized that the S&L was insolvent and would have taken steps to close the S&L much sooner.<sup>165</sup>

Thus, in proving the causation element, the FDIC could most persuasively argue that the accountants' audits were a "substantial factor" in the causation of the S&Ls' losses because both the Board of Directors and the regulators relied upon the accountants' audits of the S&L, and due to their reliance, the directors and regulators failed to take remedial actions (such as restricting S&L loans or placing the S&L into receivership), and as a result, S&L losses mounted.<sup>166</sup>

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159. See, e.g., Complaint, FDIC v. Ernst & Young, *supra* note 63, at 26-29.

160. See PROSSER AND KEETON, *supra* note 94, at § 41.

161. *Id.*

162. *Id.*

163. E.g., Complaint, FSLIC v. Fitzpatrick, *supra* note 36, at 45 ("[h]ad BHSL known the true facts, it would not have continued the business practices that resulted in its financial ruin").

164. 12 C.F.R. § 563.90 (1991). See also Complaint, FDIC v. Ernst & Young, *supra* note 63, at 28; FDIC Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 22 ("If Western had been reported to be insolvent, it would have been subject to immediate supervisory action and legally incapacitated from making any commercial loans or residential loans larger than \$500,000 — cutting off the type of speculative lending that led to its spectacular losses."); Norton, *Lending Limitations and National Banks under the 1982 Banking Act*, 101 BANKING L.J. 122 (1984).

165. See, e.g., Complaint, FDIC v. Ernst & Young, *supra* note 63, at 28.

166. E.g., Complaint, FSLIC v. Fitzpatrick, *supra* note 36, at 45 ("BHSL [Beverly

As a rebuttal to the FDIC's causation argument, accountants could assert that their audits did not *cause* the S&L's losses because even if the audits were faulty, corrupt S&L directors did not rely upon the audit reports because they knew about the S&L's true insolvent condition.<sup>167</sup> Accountants could also argue that the FDIC did not rely upon

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Hills Savings and Loan] and the regulatory agencies were unaware of the true facts . . . had the regulatory agencies known the true facts, they would not have permitted BHSL to continue such business practices.'").

167. See, e.g., Defendants' Memorandum in Support of Their Motion for Summary Judgment at 19-29, FDIC v. Ernst & Young, No. CA3-90-0490-H (N.D. Tex. filed Feb. 19, 1991) [hereinafter Defendant's Memo, FDIC v. Ernst & Young] (accountants' breach of duty in performing audits could not have caused S&L's losses if S&L chairman of the Board had committed fraud, knew the true state of the S&L's financial condition, and thus did not rely on faulty audits).

In the first written opinion in the FDIC's suits against accounting firms for S&L audits, the district court in *FDIC v. Ernst & Young* granted the defendant accounting firm's motion for summary judgment. Memorandum and Order, FDIC v. Ernst & Young and Arthur Young and Company, No. CA3-90-0490-H (N.D. Tex. dismissed Sept. 30, 1991). See also Blumenthal & Moses, *Judge Blocks Regulators' Attempt to Tie Accountant to S&L Failure*, Wall. St. J., Oct. 2, 1991, § B, at 4, col. 2.

The court held that the FDIC did not establish the causation element of its negligence claim — that the Ernst and Young 1984 and 1985 audits caused Western Savings Association's losses. In its analysis of the causation element, the court stated that due to the nature of accounting negligence claims, a plaintiff must establish causation by showing that there was reliance on the audit and that such reliance caused the institution's losses. *Id.* at 7-8. In determining reliance, the court stated that in this case, because Western's fraudulent CEO, Board chairperson, and 100% owner, Jarrett E. Woods, Jr., knew the true state of Western's financial condition, he could not have relied on the faulty audits. Moreover, the court found that because Woods's knowledge was imputable to Western (because Woods's acts were made on behalf of Western), Western therefore knew of its true financial condition, and thus Western did not rely upon the accountants' faulty audits, so the audits did not cause the S&L's losses. *Id.* at 11. Thus, in its multi-layered analysis of the causation element, the district court's opinion focused on the subissue of reliance on the audits, the reliance subissue of the imputation doctrine, and the imputation subissue of benefit to the S&L.

However, it would appear that the district court incorrectly analyzed the imputation sub-issue in this case. The district court stated that the general rule is that if an officer's fraudulent acts were made on behalf of the S&L (or bank), then the officer's knowledge is imputed to the S&L (or bank). *Id.* at 10. However, having stated the rule, the court determined that because Woods's fraudulent acts were made on behalf of Woods (because as sole shareholder, he benefited from his fraud), Woods's knowledge of Western's true financial condition could be imputed to Western. It would appear that the district court did not follow the rule that it declared. The test, as described by this court, for imputing Woods's knowledge to Western is whether Woods's acts benefited the S&L, not whether Woods's acts benefited Woods. Just because Woods, as sole shareholder, benefited by his fraudulent acts, does not mean that Western benefited. Rather, because Woods's fraudulent acts were not made on behalf of the S&L, his knowledge should not be imputed to the S&L, and therefore the S&L did not know of its true financial condition, and upon receiving the accountants' audits, did rely upon the audits, and such reliance would

the accountants' report either because the FDIC made an independent assessment of the S&L's financial statements in its own examinations, or because the S&L still would not have closed due to lack of the FDIC's personnel, funds, or political interference, despite the results of an adequate audit report.<sup>168</sup>

Even if it is established that the accountants' audits were one of the causes of the S&Ls' losses, the FDIC must prove that the accounting firm was the proximate cause of the S&L's losses, thus making it legally responsible for the losses.<sup>169</sup> An accounting firm could argue that other intervening, superseding causes precipitated the S&L's losses, thereby relieving them of liability. These superseding causes would include: (1) economic conditions (the drop in the real estate market and the drop in oil prices); (2) bad loans made prior to the audit which would have resulted in losses regardless of the audit; (3) management fraud which hid the institution's true financial picture from the auditors; (4) failure by federal examiners to examine S&Ls adequately; (5) negligence by both regulators and politicians in failing to close down S&Ls sooner; or (6) management negligence after the S&L take-over.<sup>170</sup>

In traditional tort analysis, intervening causes become superseding causes (thus relieving the defendant of responsibility) only if the intervening causes were unforeseeable.<sup>171</sup> Therefore, accountants could argue that it was unforeseeable that real estate and oil prices would drop, that S&L management would commit fraud against the auditors by "hiding the real books," or that regulators or politicians would be negligent. From an auditor's viewpoint, these superseding causes would be the proximate cause of S&L losses, not the accountant's audit.

Clearly, the causation element will be a battleground in the FDIC's suits against accounting firms for their audits of S&Ls. Causation is a "fact-sensitive" element, and facts such as the timing of loans in relation to the state of the economy and corrective regulatory action, as well as the extent of management misconduct and possible regulator negligence, will determine the success of the accountants' argument that superseding causes were to blame for S&L losses.

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appear to have caused the S&L's losses. Upon the FDIC's appeal of *FDIC v. Ernst & Young*, it will be interesting to discover the appellate court's resolution of this pivotal imputation subissue. It should also be noted that a similar imputation subissue arises in an accounting firm's contributing negligence defense. See *infra* notes 185-89 and accompanying text.

168. Hirschberg & Univer, *supra* note 96, at 128.

169. PROSSER AND KEETON, *supra* note 94, at § 92.

170. Telephone interviews with D. Jeffrey Hirschberg, Associate General Counsel of Ernst & Young (Nov. 8, 1990, Nov. 16, 1990).

171. PROSSER AND KEETON, *supra* note 94, § 44.

4. *Injury or Damage.*—As the final element of a negligence claim, the FDIC must also establish the damage or injury caused by the accountants' audits. Given the stratospheric losses of many failed S&Ls, this final element should not be difficult for the FDIC to prove in its actions against S&L accountants.<sup>172</sup>

5. *Public Policy.*—In addition to establishing the elements of negligence, the FDIC could also argue that public policy favors holding negligent accounting firms liable for their audits of failed savings and loan institutions. The FDIC will argue that it is "good public policy" to encourage public confidence in financial institutions and that for nearly sixty years, this public policy has been furthered by federally insured deposits. The FDIC could argue that the policy of encouraging public confidence in financial institutions will be greatly undermined if the public perceives that the financial institutions that are entrusted to insure deposits, instead, merely insure that unscrupulous professionals will prosper and that the taxpayers will foot the bill.

In response, accountants could argue that no good public policy interest will be served by bankrupting and destroying the major accounting firms of the United States through unprecedented lawsuits and damage awards.<sup>173</sup> With few national financially solvent accounting firms remaining, accounting services will be more scarce and cost-prohibitive, resulting in fewer audits or less thorough audits, which, in turn, will create greater opportunities for fraud and corruption in corporations and financial institutions.<sup>174</sup> Thus, accountants could argue that imposing liability on accounting firms would not be in the long-term best interest of the public.

#### *D. Affirmative Defense of Contributory Negligence in Suits Against Accountants for S&L Audits*

In the FDIC's cases against accounting firms, even if the FDIC established the elements of a negligence claim, accounting firms might

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172. E.g., Complaint, FDIC v. Ernst & Young, *supra* note 63, at 28 (FDIC's complaint alleges that due to Ernst & Young's 1984 audit, Western Savings and Loan Association suffered damages in excess of \$450 million and that as a result of Ernst & Young's 1985 audit, Western suffered damages in excess of \$110 million).

173. Marcotte, *Accountants Under Seige: Fourteen of Biggest Firms Endangered by S&L Suits, Lawyer Warns*, 77 A.B.A. J. 20, 20 (Jan. 1991).

174. Accountants could argue that expansive liability for the major national accounting firms will result in a shortage of the most sophisticated national accounting firms. Accountants could cite as an example the FDIC's problems employing accounting firms with the requisite sophistication for its suits while avoiding using firms it is currently suing. In light of this shortage, the FDIC has hired four of the same accounting firms that it is currently suing for the firms' S&L audits. Himmelstein, *RTC Officials Eye 140 Suits Against Lawyers*, N.Y.L.J., Nov. 29, 1990, at 4.

be able to assert the affirmative defense of contributory negligence.<sup>175</sup>

First, the availability of this defense will depend upon a court's interpretation of contributory or comparative negligence in the context of accountants' liability cases. Some courts (usually operating under an absolute contributory negligence rule) have only permitted accountants to assert the contributory negligence defense when the client's negligence was great enough to have contributed to the accountant's failure to perform a proper audit.<sup>176</sup> Recently, other courts (usually relying on comparative negligence statutes) have permitted accountants to assert the client's negligence as a defense without any proof that the client's negligence interfered with the accountant's ability to perform the audit.<sup>177</sup> Thus, in FDIC's suits against accounting firms, if the suit is brought in a contributory negligence jurisdiction, courts might only permit an accounting firm to assert the S&L management's contributory negligence as a defense when the management's own

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175. Although the contributory negligence defense would be the most common defense asserted by accounting firms sued by the FDIC, an accounting firm might also make use of the "informational tort" defense, failure to mitigate damages defense, assumption of risk defense, failure to warn defense, "equitable immunity set-off" defense, or estoppel. E.g., Reply Memorandum for Plaintiff at 31-36, 61-67, FDIC v. Ernst & Whinney, No. CIV-3-87-364, (E.D. Tenn filed June 11, 1990). See also Kolb, *Defending Accountants in Bank Failure Litigation*, FAILING FINANCIAL INSTITUTIONS: A.L.I. - A.B.A. COURSE OF STUDY MATERIALS 135, 141 (Oct. 11-12, 1990).

176. Fullmer v. Wohlfeiler & Beck, 905 F.2d 1394 (10th Cir. 1990) (accountant cannot use comparative negligence as a defense unless the client's negligence contributed to the accountant's inability to perform work or to furnish accurate accounting information). E.g., National Surety Corp. v. Lybrand, 256 A.D. 226, 9 N.Y.S.2d 554 (1939) (accountant may use contributory negligence as a defense only when the client's negligence contributed to the accountant's failure to perform the contract and to report the truth). Accord Shapiro v. Glekel, 380 F.Supp. 1053, 1058 (S.D.N.Y. 1974); Cereal Byproducts Co. v. Hall, 132 N.E.2d 27, 29 (Ill. App. Ct. 1956) (accountant may use contributory negligence as a defense only when there is evidence that the client's conduct contributed to the negligence of the accountant's audit); Lincoln Grain Inc. v. Coopers & Lybrand, 216 Neb. 433, 345 N.W.2d 300 (1984). See also Hawkins, *supra* note 122, at 797; Leibensperger & Wood, *Defenses of Accountants Based on Client's Negligence or Intentional Wrongdoing*, IIIB ABA SECTION OF LITIGATION 1 (Oct. 1990); Menzel, *The Defense of Contributory Negligence in Accountant's Malpractice Actions*, 13 SETON HALL L. REV. 292 (1983); Note, *The Peculiar Treatment of Contributory Negligence in Accountants' Liability Cases*, 65 N.Y.U.L. REV. 329; Tucker & Eisenhofer, *supra* note 102, at 18.

177. E.g., Devco Premium Fin. Co. v. North River Ins. Co., 450 So. 2d 1216 (Fla. Dist. Ct. App. 1984), *review denied*, 458 So. 2d 272 (Fla. 1984) (accountant may assert comparative negligence as a defense regardless of whether client's negligence impaired accountant's audit); Capital Mortgage Corp. v. Coopers & Lybrand, 142 Mich. App. 531, 369 N.W.2d 922, 925 (1985) (accountant may assert comparative negligence as a defense to claim audit failed to detect embezzlement without having to show that client's negligence affected accountant's ability to audit). See also Leibensperger & Wood, *supra* note 176, at 6-8.

negligence was so substantial that it interfered with the accountants' ability to audit the S&L. However, if the suit is brought in a comparative negligence jurisdiction, courts will most likely allow an accounting firm to assert the S&L management's negligence as a defense regardless of whether the management's negligence interfered with the accounting firm's ability to perform a proper audit.

If the contributory negligence defense in accountants' liability cases is recognized in a given jurisdiction, the second issue will be which type of contributory negligence defense may be asserted by an accounting firm. An accounting firm might assert two different contributory negligence defenses: (1) a *direct* contributory negligence defense — that the FDIC was contributorily negligent based upon the *FDIC*'s conduct as regulator or (2) a *derivative* contributory negligence defense — that the FDIC was contributorily negligent based upon the *S&L management's* conduct that is imputed to the FDIC because it "stands in the shoes" of the failed S&L.<sup>178</sup>

As for the *direct* contributory negligence defense, an accounting firm might argue that the *FDIC*, in its capacity as regulator and insurer, was contributorily negligent in its regulation of the S&L, and thus the FDIC should not be allowed to recover damages<sup>179</sup> (or in a comparative negligence jurisdiction, that the FDIC's damages should be reduced in proportion to its own fault).<sup>180</sup> However, because the FDIC operates in two separate legal capacities — in a "corporate" capacity as regulator and insurer and in a "trustee" capacity as receiver, conservator, or assignee — courts have held that a party may not assert affirmative defenses which arise out of the FDIC's actions as regulator or insurer in an action in which the FDIC is a receiver, conservator, or assignee.<sup>181</sup> Thus, in the FDIC's suits against accounting firms for their S&L audits, the accounting firms may not assert a contributory negligence defense against the FDIC in its capacity as receiver, conservator, or assignee on the basis of possible FDIC negligent acts in its capacity as regulator and insurer.

However, even if accountants could establish the FDIC's negligence as regulator as an affirmative defense, it is unlikely that they would do so. Rather, accountants would argue that both independent ac-

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178. Kolb, *supra* note 175, at 138-41. See also Hirschberg & Univer, *supra* note 96, at 128-29.

179. Hirschberg & Univer, *supra* note 96, at 128-29.

180. PROSSER AND KEETON, *supra* note 94, § 67.

181. See Murphy, *FDIC, FSLIC, and Claims Against Other Than Directors and Officers*, FAILING FINANCIAL INSTITUTIONS: A.L.I. - A.B.A. COURSE OF STUDY MATERIALS 203, 208 (Nov. 5-6, 1987); Note, *FDIC and FSLIC Pursuit of Claims Against Officers, Directors, and Others Involved With Failed Thrifts*, 58 Miss. L.J. 89, 119 (1988).

countants and regulator auditors properly performed their audits, and the regulators' failure to detect the S&L's problems is evidence that the independent accountants could not have detected the problems either.<sup>182</sup> Moreover, even if the contributory negligence of the FDIC as regulator was asserted, due to the special legal status given to the FDIC as a regulatory governmental agency, such a defense would be unsuccessful.<sup>183</sup>

As for the *derivative* contributory negligence defense, accountants might argue that the FDIC was contributorily negligent due to the *S&L management's* misconduct which may be imputed to the FDIC. Courts have established the general rule that the knowledge or wrongdoing of an institution's agent may be imputed to the institution.<sup>184</sup> However, courts have made a further distinction by stating that the wrongdoing of a corporation's management can only be imputed to the corporation when the management acts on *behalf* of the corporation,<sup>185</sup> or expressed conversely in what is called the "adverse interest exception," the wrongdoing of a corporation's management cannot be imputed to the corporation when the management acts to the *detriment* of the corporation.<sup>186</sup> Thus, the FDIC could respond that

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182. Kolb, *supra* note 175, at 141.

183. Hirschberg & Univer, *supra* note 96, at 129. *E.g.*, Emch v. United States, 630 F.2d 523 (7th Cir. 1980), *cert. denied*, 450 U.S. 966 (1981) (government has not waived sovereign immunity in regulation of financial institutions because it is engaged in discretionary activity); FDIC v. Ernst & Whinney, No. CIV-3-87-364 (E.D. Tenn. Dec. 15, 1987) (FDIC's pre-closing activities not subject to ordinary tort affirmative defenses).

184. RESTATEMENT (SECOND) OF AGENCY § 219 (1969). See also PROSSER & KEETON, *supra* note 94, §§ 69-70; Defendants' Memo, FDIC v. Ernst & Young, *supra* note 167, at 19-29; Defendants' Reply Brief in Support of Their Motion for Summary Judgment at 2, FDIC v. Ernst & Young & Arthur Young & Co., No. CA3-90-0490 (N.D. Tex. filed Apr. 19, 1991) [hereinafter Defendants' Reply Brief, FDIC v. Ernst & Young]; FDIC's Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 8.

185. Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449 (7th Cir.), *cert. denied*, 459 U.S. 880 (1982). In *Cenco, Inc. v. Seidman & Seidman*, a company sued its auditors, and the auditors asserted the wrongdoing of the company's management as a defense. The Seventh Circuit Court of Appeals held that because the company's managers were acting for the benefit of the company, their wrongdoing could be imputed to the company, and thus the auditors could use the wrongdoing of the company's managers as a defense. *Id.* at 456. The court reasoned that a judgment for the company would have had the effect of rewarding the managers for their misconduct because they were also shareholders in the company. *Id.* at 455.

186. Schacht v. Brown, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002 (1983). In *Schacht v. Brown*, the Seventh Circuit Court of Appeals held that management misconduct could not be imputed to the corporation when the management's actions were adverse to the corporation. In *Schacht*, the state of Illinois (as the receiver of an insurance company) sued the insurance company's auditors, and the auditors asserted the wrongdoing of the insurance company's management as a defense. The court held that because the

the FDIC is not contributorily negligent due to the wrongdoing of S&L management because under the "adverse interest exception," the wrongdoing of the S&L's management cannot be imputed to the S&L and subsequently to the FDIC because the S&L managers acted to the detriment of the S&L.<sup>187</sup> Therefore, an accounting firm most likely could not succeed on the derivative contributory negligence defense.<sup>188</sup>

Another FDIC argument against the imputation of the S&L management's misconduct to the S&L and subsequently to the FDIC is to distinguish between the S&L management and the S&L institution. The FDIC could argue that because the FDIC could sue the S&L management if it desired, S&L management and the S&L institution/FDIC are not one in the same. Thus, the misconduct of the S&L management should not be imputed to the S&L institution and subsequently to the FDIC in a contributory negligence defense.<sup>189</sup> However, an accounting firm might respond that, if the FDIC is allowed to divorce itself from S&L management, so too should an accounting firm be allowed to divorce itself from its few incompetent auditors.<sup>190</sup>

In summary, in the FDIC's suits against accounting firms for the accountants' audits of failed S&Ls, the FDIC may have difficulty

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insurance company's management had acted to the detriment of the company, the wrongdoing of management could not be imputed to the company or subsequently to the receiver. Therefore, the auditors could not use the wrongdoing of the company's managers as a defense. *Id.* at 1347. *Accord* Tew v. Chase Manhattan Bank, N.A., 728 F. Supp. 1551, 1560 (S.D. Fla. 1990); *In re Wedtech*, 81 Bankr. 240, 241 (S.D.N.Y. Bankr. 1987); *In re Investors Funding Corp. Sec. Litig.*, 523 F. Supp. 533 (S.D.N.Y. 1980); Holland v. Arthur Andersen & Co., 127 Ill. App. 3d 854, 469 N.E.2d 419 (1984); Bonhiver v. Graff, 248 N.W.2d 291 (Minn. 1976). *See also* Tucker & Eisenhofer, *supra* note 102, at 18-19.

187. *See, e.g.*, Defendant's Memo, FDIC v. Ernst & Young, *supra* note 167, at 19-29; FDIC's Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 8-17; Tucker and Eisenhofer, *supra* note 102, at 18.

188. It should be noted that in *FDIC v. Ernst & Young and Arthur Young & Co.*, the accountants argued an exception to the "adverse interest exception" — the "sole representative exception." Defendants' Reply Brief, FDIC v. Ernst & Young, *supra* note 184, at 2-8. In their brief, the accountants asserted that even though under the "adverse interest exception" the management's wrongdoing cannot be imputed to the corporation if the management acted to the detriment of the corporation, under the "sole representative doctrine," if the manager is a "sole owner, sole representative, or alter ego of the corporation" and acts to the detriment of the corporation, then the manager's wrongdoing may be imputed to the corporation. *Id.* In its responding brief, the FDIC argued that the "sole representative doctrine" had never been rigidly applied in Texas courts (the applicable law of the case) and charged Ernst & Young with misstating the "sole representative doctrine." FDIC's Surreply and Supporting Brief to Defendants' Motion for Summary Judgment at 1-9, FDIC v. Ernst & Young and Arthur Young and Co., No. CA3-90-0490-H (N.D. Tex. filed Apr. 26, 1991).

189. *See, e.g.*, FDIC's Brief in Opposition, FDIC v. Ernst & Young, *supra* note 152, at 8-17.

190. Cenco, Inc. v. Seidman & Seidman, 686 F.2d 449, 456 (7th Cir. 1982).

establishing the causation element of its negligence claims due to the possibility that corrupt S&L management did not rely on the faulty audits or due to other superseding causes. However, it would appear that the FDIC might be able to establish causation nevertheless, and if the FDIC is able to "jump the causation hurdle," could most likely also defeat a contributory negligence claim offered by an accounting firm — either a direct contributory negligence defense or a derivative contributory negligence defense.

#### V. CONCLUSION

Although the precise causes of the savings and loan crisis will be debated for years to come, there are indications that some accountants' S&L audits were a contributing factor in the culmination of that crisis. Although determinations of liability may only be made in a court of law after careful scrutiny of the facts in each case,<sup>191</sup> the evidence suggests that accountant behavior during the savings and loan crisis could be placed on a continuum. In some cases, ethical accountants may have stood firm, in spite of pressure from their S&L clients to adjust accounting procedures or to issue unqualified audit opinions.<sup>192</sup> In other cases, diligent accountants may have failed to detect well-concealed fraud and may have been the victims of fraud and deceptive S&L management tactics. In other situations, some accountants may have been unable to keep pace with the rapid changes in the S&L industry following federal and state deregulation. However, it would appear that in some circumstances, S&L accountants sacrificed traditional values of the accounting profession — conservatism, skepticism, objectivity, and independence — and either "looked the other way" in order to retain S&L auditing business, or deliberately participated in and benefited from the pillaging of S&Ls.

Clearly, the wrongdoing of some accountants should not implicate all S&L auditors, nor should accountants be used as "deep pockets" to pay for the wrongful acts of others in the S&L crisis. To the extent that accounting firms' financial positions attract unwarranted suits, they should remain immune.

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191. Audits are fact intensive exercises, and litigation concerning those audits is fact intensive as well. Kiernan, *supra* note 149, at 247.

192. Not to be forgotten are accountants who, in the face of misconduct by S&L directors and officers, stood firm and refused management's efforts to modify audit reports. As Judge Sporkin wrote in *Lincoln Savings & Loan Association v. Wall*, "While there are few heroes in this saga, Ms. Vincent must be commended for standing firm on the proper accounting for this transaction. Indeed, she maintained her position despite attempts made by Keating to have her removed from the audit." *Lincoln Sav. & Loan Ass'n v. Wall*, 743 F. Supp. 901, 941 (D.D.C. 1990).

However, the S&L accountants who "looked the other way" as thrift management drove S&Ls into insolvency, or who actively participated in concealing institutional losses from FDIC regulators and trusting depositors, should receive severe penalties and be assessed substantial damages. Those accountants must be held accountable for their role in one of the largest financial disasters in our nation's history.<sup>193</sup>

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193. Rosenbaum, *As Session Winds Up, G.O.P. Plans for TV Time*, N.Y. Times, Nov. 24, 1991, § 1, at 34, col. 1 (the savings and loan debacle is "the biggest disaster in public finance in American history").

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**APPENDIX A**  
**FDIC AND RTC LAWSUITS AGAINST ACCOUNTING FIRMS**  
**FOR ACCOUNTANTS' AUDITS OF FAILED S&LS**

The FDIC and RTC have the following lawsuits pending against accounting firms for their audits of failed savings and loan associations (as of October 7, 1991):

STATE	SAVINGS & LOAN	SUIT, DOCKET#, COURT	DAMAGES*
AR	FirstSouth, FA	<i>FDIC v. Deloitte &amp; Touche and Deloitte, Haskins &amp; Sells</i> LR-C-90-520 (USDC ED AR)	\$480 million
CA	Homestate S&LA	<i>FSLIC v. Bitticks &amp; Co.</i> C-88-3756-WWS (USDC ND CA)	\$4 million
CA	Imperial Savings Association	<i>RTC as Conservator for Imperial Savings v. Ernst &amp; Whinney, Union Bank, Victor Sy, and Ernst &amp; Young</i> 90-0374-JLI (USDC SD CA)	\$26 million
FL	Amerifirst FS&LA	<i>Amerifirst FS&amp;LA and Amerifirst Development Corp. v. Thomas R. Bomar et al.</i> (Deloitte, Haskins & Sells and Ernst & Whinney) 90-0429-CIV (USDC SD FL)	\$75 million
FL	Commonwealth FS&LA	<i>RTC as Conservator for Commonwealth FS&amp;LA v. Jason Chapnick, Deloitte, Haskins &amp; Sells, et al.</i> 89-6572-CIV-JCP (USDC SD FL)	\$50 million
FL	Duvall FS&LA	<i>RTC as Conservator for Duvall FS&amp;LS v. Peat Marwick</i> 89-085-48 CA (4th Jud. Cir. Ct.)	\$16.6 million
FL	Royal Palm FS&L	<i>RTC as Conservator for Royal Palm FS&amp;L v. Deloitte, Haskins &amp; Sells</i> 89-8039-CIV-PAINE (USDC SD FL)	Amount undetermined

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\* Approximate figures

FL	Sunrise S&LA	<i>FDIC v. Jacoby, et al.</i> (Deloitte Haskins & Sells) MDL 655 (USDC ED PA)	\$250 million
KS	Rooks County FS&LA	<i>Roger Comeau, et al. v. Terry Rupp, et al.</i> (Grant Thornton) 86-1531-T (USDC KS)	\$15 million
KY	Henderson Bank Home S&LA	<i>RTC v. Logan Campbell</i> 89-CI-1-89 (USDC WD KY)	Amount undetermined
LA	Crescent FSB	<i>FDIC v. Kevin C. Schoenberger, et al.</i> (J.K. Byrne & Co.) 89-2756S-L/M-2 (USDC ED LA)	\$40 million
MN	Midwest Federal S&L	<i>Midwest Federal S&amp;LA v. Greentree Acceptance, Inc., et al.</i> (Touche, Ross & Co.) 3-88-669 (USDC MN)	\$192 million
OK	People's Federal	<i>RTC as Conservator for People's Federal v. Touche, Ross &amp; Co., et al.</i> 90-C-221-B (USDC ND OK)	\$467,000
OK	Territory S&LA	<i>FSLIC v. Futures, Inc. Regier, Carr &amp; Monroe</i> 88 CIV 0906 PNL (USDC SD NY)	\$12 million
PA	Atlantic Financial FS&LA	<i>RTC as Conservator for Atlantic Financial FS&amp;LA v. Laventhal &amp; Horwath</i> 90-4113 (USDC ED PA)	\$3 million
TN	Century FSB	<i>RTC as Receiver for Century FSB v. Arnold Spain &amp; Co.</i> 89-1065-TUB (USDC WD TN)	\$5.2 million
TX	Sunbelt SA of TX	<i>FDIC v. Edwin McBirney</i> (Grant Thornton) 3-89-2295-R (USDC ND TX)	\$200 million
TX	Western Savings Association	<i>FDIC v. Ernst &amp; Young &amp; Arthur Young &amp; Co.</i> CA-3-90-0490-H (USDC ND TX)	\$560 million

# **Whither the Fourth Amendment: An Analysis of *Illinois v. Rodriguez***

*The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.<sup>1</sup>*

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## **I. INTRODUCTION**

### *A. Preface*

On July 26, 1985, Edward Rodriguez broke the jaw of his girlfriend, Gail Fischer.<sup>2</sup> Gail went home to her mother, Dorothy Jackson, who

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1. U.S. CONST. amend. IV.

2. Ms. Fischer's name is spelled "Gail Fischer" in the U.S. Supreme Court's opinion. The trial court used "Gayle Fisher" and the Illinois Appellate Court used "Gale

called the Chicago police.<sup>3</sup> Rodriguez was arrested in his apartment and was charged with possession of illegal drugs, which the officers had observed in plain view while in the apartment.<sup>4</sup> The officers did not have an arrest warrant or a search warrant authorizing entry. They gained entrance with the assistance of Gail Fischer, who had a key and referred to the apartment as "ours." Rodriguez moved to suppress the evidence, arguing that Fischer had taken the key without his knowledge, and therefore, she did not have common authority over the apartment and her consent was invalid. The State of Illinois argued that even if Gail Fischer did not have actual common authority over the apartment, there was no violation of the fourth amendment if the police reasonably believed at the time of their entry that Fischer possessed the authority to consent. The trial court granted Rodriguez's motion and the Appellate Court of Illinois affirmed.<sup>5</sup> These events led to the United States Supreme Court's first statement on third party consent searches, a recognized exception to the warrant requirement of the fourth amendment since *United States v. Matlock*.<sup>6</sup>

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Fisher." The petitioner also used "Gale Fisher." The respondent used "Gail Fisher," "Gale Fisher," and finally "Gail Fischer" at various points in his Briefs. Ms. Fischer testified at the suppression hearing. At the hearing, she spelled her last name as "F-I-S-C-H-E-R." Brief for Petitioner at 4, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990) (No. 88-2018) [hereinafter Brief for Petitioner]. She did not spell her first name which is indicative of the common spelling "Gail." The fact that the trial court later spelled her name "Gayle" is ironic because the third party in *Matlock*, the landmark third party consent case, was "Gayle" (Graff). See *United States v. Matlock*, 415 U.S. 164 (1974). In addition, an amici brief refers to Gail Fischer as respondent's wife.

3. The opinions describe Gail Fischer as Dorothy Johnson's daughter. The respondent's brief uses the word "mother" and the phrase, "a law enforcement officer herself." At oral argument, Dorothy Johnson was identified as Gail Fischer's "stepmother" and as a deputy sheriff. Record at 4, 35, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990). At the suppression hearing, she identified herself as Gail's mother and a deputy sheriff. Joint Appendix at 35, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990) (No. 88-2018) [hereinafter Joint Appendix]. Under cross-examination she testified that Gail was not her natural child and stated that she had adopted Gail when Gail was three days old. *Id.* at 56.

4. The Introduction, Statement of Facts, and Statement of the Case of *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990), as written by Justice Scalia is included *infra* at Appendix I.

5. Although the Supreme Court opinion provides a citation to the Illinois Appellate Court's decision and the Illinois Supreme Court's denial of leave to appeal, the text of the appellate court's opinion is unpublished; the published portion simply states, "Affirmed." *People v. Rodriguez*, 177 Ill. App. 3d 1154, 550 N.E.2d 65, *appeal denied*, 125 Ill. 2d 572, 537 N.E.2d 816, *rev'd*, 110 S. Ct. 2793 (1990). The Illinois Supreme Court's decision states that leave to appeal is denied. *People v. Rodriguez*, 125 Ill. 2d 572, 537 N.E.2d 816 (1989), *rev'd*, 110 S. Ct. 2793 (1990). The Illinois Appellate Court's opinion and the Illinois Supreme Court's decision are included *infra* at Appendix II.

6. 415 U.S. 164 (1974).

The case presented the Court with an issue “expressly reserved in *Matlock*: whether a warrantless entry is valid when based upon consent of a third party whom the police, at the time of the entry, reasonably believe to possess common authority over the premises, but who in fact does not do so.”<sup>7</sup> The Court, in a 6-3 decision, answered this question in broad terms. Justice Scalia, writing for the majority, stated that “[w]hat he [Rodriguez] is assured by the Fourth Amendment itself, however, is not that no government search of his house will occur unless he consents; but that no such search will occur that is ‘unreasonable.’”<sup>8</sup> Justice Marshall, writing for the dissent, replied that “[w]here this free-floating creation of ‘reasonable’ exceptions to the warrant requirement will end, now that the Court has departed from the balancing approach that has long been part of our Fourth Amendment jurisprudence, is unclear.”<sup>9</sup>

In *Rodriguez*, Justice Scalia appears to simplify fourth amendment jurisprudence. No longer is it a matter of whether an applicable exception exists that will permit the admission of evidence seized without a warrant. It becomes a question of the reasonableness of police actions under the facts known to the police at the time of the seizure. This is a question of fact to be determined by the trial judge at a suppression hearing. Thus, the question of admissibility of evidence seized in a warrantless search is a question of fact, not a question of law, and the factual findings of the trial judge will not be reversed unless clearly erroneous.

It is immaterial whether or not we agree with this decision because the Court decided it 6-3, with Justice Brennan in the minority. With the elevation of Justice Souter and Justice Thomas to the Court, it is unlikely that this decision and its “reasonable” standard will change in the foreseeable future. Therefore, defense attorneys must look elsewhere

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7. Illinois v. Rodriguez, 110 S. Ct. 2793, 2796 (1990) (citation omitted).

8. *Id.* at 2799.

9. *Id.* at 2806-07 (Marshall, J., dissenting). Justice Marshall explained the balancing approach as follows:

The Court has tolerated departures from the warrant requirement only when an exigency makes a warrantless search imperative to the safety of the police and of the community. . . . The Court has often heard, and steadfastly rejected, the invitation to carve out further exceptions to the warrant requirement for searches of the home because of the burdens on police investigation and prosecution of crime. Our rejection of such claims is not due to a lack of appreciation of the difficulty and importance of effective law enforcement, but rather to our firm commitment to the view of those who wrote the Bill of Rights that the privacy of a person’s home and property may not be totally sacrificed in the name of maximum simplicity in enforcement of the criminal law.

*Id.* at 2803 (Marshall, J., dissenting) (citations omitted). Thus, the Court balanced law enforcement interests against the right of a person to be secure from unreasonable searches in his home.

to protect clients from invasions of their right to be secure in their persons, houses, papers, and effects from warrantless searches and seizures.

The approach suggested by this Note is that defense counsels turn to their state constitutions and state constitutional law. The Court has set a national, minimum standard of protection under the fourth amendment to the United States Constitution. The states may not go below this standard, but they are free to grant more protection to their citizens than the federal Bill of Rights. However, the Court has set a strict standard to enable a state decision to stand on adequate and independent state grounds. If this standard is met, the state decision will not be reviewed by the Court.

Part I of this Note discusses the history of the fourth amendment exclusionary rule, the exceptions to this rule, the development of the third party consent exception, the theories that explain this exception, and the concept of third party apparent authority, the primary question presented in *Illinois v. Rodriguez*.<sup>10</sup> Part II examines the rationale of the majority opinion by a presentation of the arguments submitted to the Court by the petitioner, respondent, and amici curiae in briefs and at oral argument. It attempts to show the rationale of the Court by identifying the arguments found most persuasive by the Court. It also provides the essence of Justice Marshall's dissent and Justice Scalia's response. Part III is both analytical and conclusionary. Part III (A) analyzes the relationship of the Court's opinion to other recognized exceptions to the warrant requirement of the fourth amendment, as well as the potential impact of *Rodriguez* upon future fourth amendment cases. Part III (B) concludes with a suggested approach for defense counsels in future fourth amendment cases and recommends an early Indiana case as a model for adequate and independent state grounds.

### B. *The Exclusionary Rule*

In the thirty years since the Supreme Court's landmark decision of *Mapp v. Ohio*,<sup>11</sup> the fifty-four words of the fourth amendment have generated more litigation than any other provision of the Bill of Rights. In *Mapp*, the Court applied the judicially-created federal exclusionary rule<sup>12</sup> to the states, holding that "all evidence obtained by searches and

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10. 110 S Ct. 2793 (1990).

11. 367 U.S. 643 (1961). *See generally* 1 W. LAFAYE, SEARCH AND SEIZURE: A TREATISE ON THE FOURTH AMENDMENT § 1.1 (2d ed. 1987) [hereinafter 1 W. LAFAYE, SEARCH AND SEIZURE].

12. The exclusionary rule, by which illegally seized evidence is suppressed at trial, evolved in the federal court system in a series of cases beginning with *Boyd v. United*

seizures in violation of the Constitution is . . . inadmissible in a state court.”<sup>13</sup> The primary rationale of the exclusionary rule has been explained as deterrence of official misconduct, protection of judicial integrity, and encouragement of the people’s trust in government.<sup>14</sup> Two other justifications for the rule have also been offered: that the defendant has a personal right to the exclusion of unlawfully seized evidence or that exclusion is designed as a form of restitution.<sup>15</sup> Of these justifications, deterrence of official misconduct by preventing the fruits of an unreasonable search or seizure to be used at trial, is considered to be the primary purpose of the exclusionary rule.<sup>16</sup>

In recent years, the Supreme Court has relied on a deterrence theory as evidenced by *United States v. Calandra*.<sup>17</sup> The *Calandra* Court described the exclusionary rule as a “judicially-created remedy designed to safeguard Fourth Amendment rights generally through its deterrent effect, rather than a personal constitutional right of the party aggrieved.”<sup>18</sup> The Court has followed this approach in other cases such as *United States v. Janis*,<sup>19</sup> *Stone v. Powell*,<sup>20</sup> and *United States v. Leon*.<sup>21</sup> The deterrent view, although not popular with many academic

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States, 116 U.S. 616 (1886). In *Boyd*, the fourth and fifth amendments were linked in the majority opinion, although a concurring opinion limited the decision to the fifth amendment privilege against self-incrimination. *Boyd* was followed by *Weeks v. United States*, 232 U.S. 383 (1914). The *Weeks* Court found that the fourth amendment required that illegally seized evidence by federal officials must be excluded, but allowed evidence obtained by state officials to be admitted because the fourth amendment was not directed to the misconduct of state officials. The Court next addressed the exclusionary rule in *Wolf v. Colorado*, 338 U.S. 25 (1949), in which a divided Court declined to apply the *Weeks* rule to state court proceedings. *Weeks* was overruled by *Mapp* in 1961. See generally, 1 W. LAFAYE, SEARCH AND SEIZURE, *supra* note 11, § 1.1(b)-(d).

13. *Mapp*, 367 U.S. at 655.

14. See generally 1 W. LAFAYE, SEARCH AND SEIZURE, *supra*, note 11, § 1.1(f).

15. Meltzer, *Deterring Constitutional Violations by Law Enforcement Officials: Plaintiffs and Defendants as Private Attorneys General*, 88 COLUM. L. REV. 247, 269-70 (1988).

16. See generally 1 W. LAFAYE, SEARCH AND SEIZURE, *supra* note 11, § 1.1(f); Meltzer, *supra* note 15, at 267-69.

17. 414 U.S. 338 (1974).

18. *Id.* at 347-48.

19. 428 U.S. 433 (1976). In *Janis*, the Court stated that the primary purpose of the exclusionary rule is to deter police misconduct. *Id.* at 446. The Court held that this purpose would not be served by prohibiting the use of evidence illegally seized by a state official in a federal civil tax proceeding. *Id.* at 459-60.

20. 428 U.S. 465 (1976). In *Stone*, the Court confirmed the statement that deterrence is the primary purpose of the exclusionary rule. *Id.* at 484. The Court denied the use of the fourth amendment exclusionary rule in a federal habeas corpus action, finding that the deterrent effect of exclusion at that stage would be minimal. *Id.* at 493.

21. 468 U.S. 897 (1984). *Leon* resulted in the “good faith” exception to the warrant

commentators,<sup>22</sup> appears to be the prevailing explanation of the exclusionary rule.<sup>23</sup>

The exclusionary rule has been the subject of much criticism.<sup>24</sup> However, in the absence of any other practical method of enforcing the fourth amendment prohibition against unreasonable searches and seizures, calls for its abandonment have been fruitless.<sup>25</sup> Instead of abandoning

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requirement. The Court found that a police officer could reasonably rely on a warrant that later proved defective. The reasoning of the Court was essentially that the deterrent purpose of the exclusionary rule was aimed at police misconduct. The misconduct, if any, was by a "neutral and detached magistrate." Thus, there would be no deterrent effect to police misconduct by excluding evidence obtained by good faith reliance on a magistrate's error.

22. See Meltzer, *supra* note 15, at 268-69. Professor Meltzer stated:

This [deterrent] view . . . is not popular with many academic commentators, particularly those who strongly support the exclusionary rule. Yet I believe the deterrent view's lack of academic popularity has less to do with its inherent defects than with the Burger Court's having followed it while cutting back on the scope of the rule. . . . I believe, nonetheless, that the deterrent rationale is the most persuasive explanation for the exclusionary remedy.

*Id.* at 268. See also 1 W. LAFAYE, SEARCH AND SEIZURE, *supra* note 11, § 1.1(f).

23. For a different view of the American exclusionary rule see Note, *Exclusion of Evidence: Exclusion of Illegally Obtained Evidence From the Prosecution's Case-In-Chief Under the Canadian Charter of Rights and Freedoms*, 4 CAN. AM. L.J. 57 (1988). Glover, the author of this Note, discusses the rationale behind the development of the American exclusionary rule from a Canadian viewpoint. Glover cites Appellate Justice Esson of the British Columbia Court of Appeals in *R. v. Strachan*, 25 D.L.R. 4th 567 (B.C.C.A. 1986), in which Justice Esson suggested that "Canada not apply the American exclusionary rule because it was developed to address problems of racism and police misconduct which are largely absent in Canada." *Id.* at 70.

24. Comment, *Third-Party Consent Searches, the Supreme Court, and the Fourth Amendment*, 75 J. CRIM. L. & CRIMINOLOGY 963, 986 n.92 (1984). See *supra* note 22.

25. See generally 1 W. LAFAYE, SEARCH AND SEIZURE, *supra* note 11, § 1.2(c); Oaks, *Studying the Exclusionary Rule in Search and Seizure*, 37 U. CHI. L. REV. 665 (1970). Professor Oaks stated:

The exclusionary rule should not be abolished until there is something to take its place and perform its two essential functions. . . . It would be intolerable if the guarantee against unreasonable search and seizure could be violated without practical consequences. It is likewise imperative to have a practical procedure by which courts can review alleged violations of constitutional rights and articulate the meaning of those rights. The advantage of the exclusionary rule—entirely apart from any direct deterrent effect—is that it provides an occasion for judicial review, and it gives credibility to the constitutional guarantees.

*Id.* at 756. The above passage was quoted with approval by Professor Lafave. Professor Lafave stated that "I find wholly satisfactory the recommendation of Professor Oaks." 1 W. LAFAYE, SEARCH AND SEIZURE, *supra* note 11, § 1.2(c). However, Professor Oaks then stated:

As to search and seizure violations, the exclusionary rule should be replaced by an effective tort remedy against the offending officer or his employer. . . . A

the rule outright, the Supreme Court's approach to the actual application of the exclusionary rule regarding the warrant requirement of the fourth amendment has been to create exceptions to the rule.<sup>26</sup>

### C. Warrantless Search and Seizure Exceptions

Professor Meltzer stated that "the much-recited (and sometimes honored) doctrine [is] that, subject to only a few well-defined exceptions, the fourth amendment requires the police to obtain warrants."<sup>27</sup> His tongue-in-cheek remark is extremely accurate. Since the creation of the exclusionary rule, the "few well-defined exceptions" for searches of places and seizure of evidence have grown to include: searches under exigent circumstances,<sup>28</sup> searches incidental to an arrest,<sup>29</sup> seizure of items in plain view,<sup>30</sup> automobile searches,<sup>31</sup> stop and frisk searches,<sup>32</sup> admin-

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practical tort remedy would give courts an occasion to rule on the content of constitutional rights . . . and it would provide the real consequence needed to give credibility to the guarantee.

Oaks, *supra*, at 756-57. Professor Oaks did not provide an example of what he considered to be "an effective tort remedy."

26. For an extensive review of recent exceptions to the warrant requirement of the fourth amendment in regard to searches of places and seizure of both evidence and persons, see Borucke, Buechler, Foley, Mejia, & Noe, *Investigation and Police Practices: Warrantless Searches and Seizures*, 77 GEO. L.J. 517 (1989) [hereinafter Borucke].

27. Meltzer, *supra* note 15, at 271. See also Katz, *In Search of a Fourth Amendment for the Twenty-first Century*, 65 IND. L. J. 549 (1990). Professor Katz stated, "Exceptions to the warrant requirement have grown so over the past two decades that the warrant requirement itself is fast becoming the exception. The formerly proclaimed judicial preference for a warrant is virtually non-existent." *Id.* at 588.

28. See, e.g., *Warden v. Hayden*, 387 U.S. 294 (1967); *Schmerber v. California*, 384 U.S. 757 (1966); *Ker v. California*, 374 U.S. 23 (1963).

29. *New York v. Belton*, 453 U.S. 454 (1981); *Michigan v. DeFillippo*, 443 U.S. 31 (1979); *United States v. Robinson*, 414 U.S. 218 (1973); *Chimel v. California*, 395 U.S. 752 (1969) (after a valid arrest, police may make a warrantless search of the suspect and the area under his immediate control to protect the police from harm and to prevent the destruction of evidence).

30. *Coolidge v. New Hampshire*, 403 U.S. 443 (1971) (police may seize evidence in plain view from a place where they are lawfully entitled to be). The plain view doctrine was extended to include an "open sky" exception. *Florida v. Riley*, 109 S. Ct. 639 (1989) (marijuana visible from a helicopter hovering 400 feet over the suspect's greenhouse was in "plain view"). See also *Dow Chem. Co. v. United States*, 476 U.S. 227 (1986) (aerial photos taken from an aircraft); *California v. Ciraolo*, 476 U.S. 207 (1986). The Court also created an "open barn" exception, *United States v. Dunn*, 480 U.S. 294 (1987), as well as an "open fields" exception, *Oliver v. United States*, 466 U.S. 170 (1984).

31. See, e.g., *Colorado v. Bertine*, 479 U.S. 367 (1987); *California v. Carney*, 471 U.S. 386 (1985); *Carroll v. United States*, 267 U.S. 132 (1925). Automobile searches led to the "inventory" exception. See, e.g., *Illinois v. Lafayette*, 462 U.S. 640 (1983); *South Dakota v. Opperman*, 428 U.S. 364, 369-70 (1976).

32. *Adams v. Williams*, 407 U.S. 143 (1972); *Terry v. Ohio*, 392 U.S. 1 (1963).

istrative searches,<sup>33</sup> private searches,<sup>34</sup> and searches based upon consent.<sup>35</sup> In addition, exceptions to the warrant requirement for the seizure of persons have also been created.<sup>36</sup> Each of these exceptions has been justified by balancing the interests of society in effective law enforcement against the fourth amendment right of an individual to be secure from unreasonable searches and seizures.<sup>37</sup>

#### D. Third Party Consent Searches

The waiver theory (*i.e.*, that a person may waive her fourth amendment rights)<sup>38</sup> for the general consent search exception appears logical and generally, if not totally, accepted.<sup>39</sup> In contrast, the expansion of the general consent exception to consent given by a third party has not stood firmly on any single theoretical basis. The waiver theory does not explain how one person [the third-party] may waive the constitutional rights of another person.<sup>40</sup> Cases prior to *Matlock* turned upon the

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33. *E.g.*, New Jersey v. T.L.O., 469 U.S. 325, 340 (1985); *Camara v. Municipal Ct.*, 387 U.S. 523, 535-39 (1967). O.S.H.A. inspections are the latest example of warrantless administrative searches.

34. *United States v. Jacobsen*, 466 U.S. 109, 113 (1984) (fourth amendment applies to official actions and is inapplicable to actions of private parties).

35. *United States v. Mendenhall*, 446 U.S. 544, 557-59 (1980) (plurality opinion) (a court will look to the totality of the circumstances surrounding the consent to determine if it was freely and voluntarily given); *United States v. Matlock*, 415 U.S. 164, 167 n.2 (1974) (on remand, district court need not determine if lack of warning about right to refuse consent invalidates third party's consent); *Schneckloth v. Bustamonte*, 412 U.S. 218, 220 (1973) (consent must be voluntary, but need not be knowingly and intelligently given); *Bumper v. North Carolina*, 391 U.S. 542 (1968) (consent must be freely and voluntarily given). Consent to a search is considered to be a voluntary waiver of an individual's fourth amendment rights. *Schneckloth v. Bustamonte*, 412 U.S. 218, 219 (1973); *Davis v. United States*, 328 U.S. 582 (1946); *Zap v. United States*, 328 U.S. 624 (1946), *vacated*, 330 U.S. 800 (1947); *Amos v. United States*, 255 U.S. 313 (1921). For factors considered by courts in cases of consent searches, see Borucke, *supra* note 26, at 554-64, and for a discussion of waiver as a basis for consent searches, see Comment, *supra* note 24, at 985-94.

36. See generally Borucke *supra* note 26, at 529-36.

37. See *supra* note 9.

38. See *supra* note 35.

39. Comment, *supra* note 24, at 985-94. The author of this Comment argued that the Court has essentially abandoned the waiver theory as a basis for the general consent exception to the warrant requirement of the fourth amendment. She stated that "[b]oth exceptions [general and third party consent] can be supported by arguments based upon the convenience and efficiency of law enforcement officers. Efficiency, however, should not be a sufficient excuse for abandoning fourth amendment protections." *Id.* at 993. She then concluded that "the Court has left us with no theory at all to support either the general consent exception or the third party consent exception." *Id.*

40. *Id.* at 988-89.

presence or absence of an express or implied agency relationship<sup>41</sup> or joint control.<sup>42</sup> The implied agency theory was abandoned by the Supreme Court in *Stoner v. California*.<sup>43</sup> However, the *Stoner* Court also stated that an express agency relationship would support a waiver of the defendant's fourth amendment rights by a third party.<sup>44</sup> The "joint control/common authority" concept of *Frazier v. Cupp*<sup>45</sup> became the basis for the Supreme Court's decision in *Matlock*.

In *United States v. Matlock*,<sup>46</sup> the Supreme Court delivered its most recent statement on the third party consent search exception until *Illinois v. Rodriguez*. In *Matlock*, the Court determined that the police need only have the voluntary consent of a third party who possesses "common authority" or a "sufficient relationship" to the area to be searched.<sup>47</sup>

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41. *Bumper v. North Carolina*, 391 U.S. 543, 548 (1968) (consent by the third party grandmother to search of house and seizure of evidence against another valid if voluntarily given); *Stoner v. California*, 376 U.S. 483, 487-89 (1964) (consent by hotel clerk to search of guest's room invalid); *Chapman v. United States*, 365 U.S. 610 (1961); *Weeks v. United States*, 232 U.S. 383 (1914). An agency relationship is created when "authority to do an act can be created by written or spoken words or other conduct of the principal which, reasonably interpreted, causes the agent [third party] to believe that the principal desires him to so act." *RESTATEMENT (SECOND) OF AGENCY* § 26 (1958).

42. *Frazier v. Cupp*, 394 U.S. 731 (1969) (consent search of a duffle bag under control of third party held valid against owner of the bag based upon common/joint control).

43. 376 U.S. 483 (1964). In rejecting an implied agency relationship between the hotel and its guest, the Court stated, "Our decisions make clear that the rights protected by the Fourth Amendment are not to be eroded by strained applications of the law of agency. . . ." *Id.* at 488.

44. *Id.* at 489. The Court stated that the fourth amendment right of the petitioner [*Stoner*] was "a right, therefore, which only the petitioner could waive by word or deed, either directly or through an agent." *Id.* For a discussion of agency theory and consent searches, see Note, *The Problem of Third-Party Consent in Fourth Amendment Searches: Toward a "Conservative" Reading of the Matlock Decision*, 42 ME. L. REV. 159, 162 n.21 (1990).

45. 394 U.S. 731 (1969).

46. 415 U.S. 164 (1974). The Court upheld the consent to a police search of a bedroom by a third party, Gayle Graff, with whom the defendant had been sharing the bedroom. Noting that both parties' personal items were in the room, the Court held that her consent was based upon her mutual use of the room as well as her joint access and control of the room. In addition, the facts indicated to the Court that Matlock had assumed the risk that his co-inhabitant would allow a police search. *Id.* at 171.

47. *Id.* at 171 n.7. The Court stated:

Common authority is, of course, not to be implied from the mere property interest a third party has in the property. The authority which justifies the third-party consent does not rest upon the law of property, with its attendant historical and legal refinements. . . . but rests rather on mutual use of the property by persons generally having joint access or control for most purposes, so that it is reasonable to recognize that any of the co-inhabitants has the right to permit

Thus, under *Matlock*, the consent must be voluntary<sup>48</sup> and must be given by one having the requisite authority over, or common relationship to, the area to be searched. The Court, for the first time, stated that third party consent is based on the third party's "own right" over the premises<sup>49</sup> and thus, the third party's right to cooperate with a police investigation overcomes any invasion of the principal's area.<sup>50</sup> The policy of encouraging citizen cooperation with police inquiries is the justification for the third party consent exception.<sup>51</sup> The concept that the principal assumes the risk that a third party will consent to a search is based upon the "reasonable expectation of privacy" test developed by the Court in *Katz v. United States*.<sup>52</sup>

In *Katz*, the Court stated that the purpose of the fourth amendment is to "protect people, not places."<sup>53</sup> In a concurring opinion, Justice Harlan set forth a two part test for the "expectation of privacy"<sup>54</sup> of the principal: First, a person must exhibit an actual (subjective) expectation of privacy and second, the person's expectation must be one that society is prepared to accept as reasonable (objective).<sup>55</sup> Unless both tests are met, the defendant is deemed to have assumed the risk of a search and therefore is not entitled to fourth amendment protection.<sup>56</sup> To justify

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the inspection in his own right and that the others have assumed the risk that one of their number might permit the common area to be searched.

*Id.*

48. See *supra* note 35.

49. See *supra* note 47.

50. Note, *supra* note 44, at 162.

51. *Coolidge v. New Hampshire*, 403 U.S. 443, 488 (1971) ("[I]t is no part of the policy underlying the Fourth . . . Amendment to discourage citizens from aiding to the utmost of their ability in the apprehension of criminals."). *Schneckloth v. Bustamonte*, 412 U.S. 218, 231 (1973). ("[C]onsent searches are part of the standard investigatory techniques of law enforcement agencies.").

52. 389 U.S. 347 (1967).

53. *Id.* at 351. Thus, the fourth amendment protects privacy interests, not property interests.

54. *Id.* at 361 (Harlan, J., concurring). Justice Harlan explained:

As the Court's opinion states, the "Fourth Amendment protects people, not places." The question, however, is what protection it affords to those people. Generally, as here, the answer to that question requires reference to a "place." My understanding of the rule that has emerged from prior decisions is that there is a twofold requirement, first that a person have exhibited an actual (subjective) expectation of privacy, and, second, that the expectation be one that society is prepared to recognize as "reasonable." Thus a man's home is, for the most purposes, a place where he expects privacy, but objects, activities, or statements that he exposes to the "plain view" of outsiders are not "protected" because no intention to keep them to himself has been exhibited.

*Id.*

55. *Id.*

56. Note, *supra* note 44, at 182.

third party consent searches, the *Matlock* Court combined the *Katz* "reasonable expectation of privacy" test with requirements that the third party have "common authority over" and "sufficient relationship to the area." However, courts split dramatically on the meaning of these terms with contradictory results.<sup>57</sup>

The *Matlock* Court expressly reserved the issue of the apparent authority of a third party to consent to a search, stating "we do not reach another major contention of the United States . . . that the Government in any event only had to satisfy the District Court that the searching officers reasonably believed that Mrs. Graff [the third-party] had sufficient authority [to consent]."<sup>58</sup> Courts that addressed the question of apparent authority, prior and subsequent to *Matlock*, also split. Some courts held that the government must always prove actual authority of the party consenting, no matter what the appearances.<sup>59</sup> Others held that for apparent authority to be effective, the officer must take some affirmative action prior to the search to ascertain the basis of the third party's authority.<sup>60</sup> The majority of courts, both state and federal, who considered the question of apparent authority to consent, adopted an objective test: The reasonable appearance of authority to consent, from the viewpoint of the officers, under the circumstances facing the officers, at the time the third party consents to a search.<sup>61</sup>

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57. See generally Note, *supra* note 44, at 167-87. Deschene, the author of this Note, stated that courts have split over the meaning of the phrases: "(1) 'common authority' vs. 'other sufficient relationship,' (2) 'mutual use' vs. 'joint access,' (3) inspection 'in his own right,' (4) 'co-inhabitants,' (5) assumption of risk, (6) 'the [extent of] common area,' and (7) 'reasonable to recognize' [apparent vs. actual authority].'" The Note provides an extensive discussion of cases illustrating each of these topics. *Id.* at 167.

58. *United States v. Matlock*, 415 U.S. 164, 177 n.14 (1974).

59. *United States v. Warner*, 843 F.2d 401, 404-05 (9th Cir. 1988) (refusing to extend the *Leon* "good faith" exception to warrantless searches when the police officer has a reasonable basis for his actions); *United States v. Harris*, 534 F.2d 95, 96-97 (7th Cir. 1976) (*Matlock* requires both actual and apparent authority); *United States v. Cook*, 530 F.2d 145, 147 (7th Cir. 1976); *People v. Vought*, 174 Ill. App. 3d 563, 528 N.E.2d 1095 (1988), *cert. denied*, 109 S. Ct. 3228 (1989); *People v. Bochniak*, 93 Ill. App. 3d 575, 417 N.E.2d 722 (1981), *cert. denied*, 455 U.S. 938 (1982); *People v. Miller*, 40 Ill. 2d 154, 238 N.E.2d 407 (1968), *cert. denied*, 393 U.S. 961 (1968); *State v. Carsey*, 59 Or. App. 225, 650 P.2d 987 (1982), *aff'd*, 295 Or. 32, 664 P.2d 1085 (1983).

60. *United States v. Sealey*, 830 F.2d 1028, 1031 (9th Cir. 1987) (police asked wife several questions to determine her control of the area); *United States v. Sledge*, 650 F.2d 1075, 1079 (9th Cir. 1981) (police attempted to ascertain landlord's authority).

61. See, e.g., *United States v. Rodriguez*, 888 F.2d 519 (7th Cir. 1989) (not related to Edward Rodriguez); *United States v. Yarbrough*, 852 F.2d 1522 (9th Cir. 1985), *cert. denied*, 109 S. Ct. 171 (1988); *United States v. Isom*, 588 F.2d 858 (2d Cir. 1978); *United States v. Peterson*, 524 F.2d 167 (4th Cir. 1975); *Nix v. State*, 621 P.2d 1347 (Alaska 1981); *People v. Gorg*, 45 Cal. 2d 776, 291 P.2d 469 (1955); *People v. Adams*, 53 N.Y.2d

A final question regarding common authority, not clearly defined by the *Matlock* Court, involves the legal status of "common authority": Whether "common authority" is a question of fact or a question of law.<sup>62</sup> The distinction becomes vital if the determination of "common authority" at a suppression hearing is raised on appeal. If "common authority" is a question of fact, the standard for appellate review is "clearly erroneous."<sup>63</sup> If "common authority" is a question of law, *de novo* review is warranted.<sup>64</sup> Courts also split regarding this question, with the majority holding that "common authority" is a question of fact,<sup>65</sup> although some courts consider "common authority" to be a mixed question of fact and law.<sup>66</sup> One recent commentator argued that "the issue of authority to consent ought to be considered at least a mixed question of law and fact."<sup>67</sup> Thus, the stage was set for the Court to consider the issues that had developed since the *Matlock* decision in 1974. The opportunity arose in the persons of Ed Rodriguez, Gail Fischer, and Officers Jim Entress and Ricky Gutierrez of the Chicago police in the case of *Illinois v. Rodriguez*.

## II. ILLINOIS V. RODRIGUEZ

### A. *The Issues Presented*

The parties in *Illinois v. Rodriguez* presented the Supreme Court with three issues. The petitioner, the State of Illinois, first argued that the *Matlock* third party consent exception to the warrant requirement should apply because Gail Fischer had common authority over the premises.<sup>68</sup> Alternatively, the State argued that even if Gail Fischer did not in fact have actual authority to consent, the entry of the officers was proper because the officers reasonably believed that she did.<sup>69</sup> The respondent, Edward Rodriguez, disagreed with the position of the State.

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1, 422 N.E.2d 537, 439 N.Y.S.2d 877, *cert. denied*, 454 U.S. 854 (1981). See also Brief for Petitioner, *supra* note 2, at 13; 3 W. LAFAVE, SEARCH AND SEIZURE, *supra* note 11, § 8.3(g).

62. *Matlock*, 415 U.S. at 169-72.

63. See, e.g., *United States v. McMurtrey*, 534 F.2d 1321 (8th Cir. 1976). "Findings of fact, whether based on oral or documentary evidence, shall not be set aside unless clearly erroneous. . . ." FED. R. CIV. P. 52(a). See also Note, *supra* note 45, at 189.

64. *United States v. McConney*, 728 F.2d 1195 (9th Cir. 1984).

65. See, e.g., *United States v. Baswell*, 792 F.2d 755, 758 (8th Cir. 1986) ("We now expressly hold that such determinations are factual issues. . .").

66. *United States v. Guzman*, 852 F.2d 1117 (9th Cir. 1988).

67. Note, *supra* note 44, at 189.

68. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2797 (1990).

69. *Id.*

Furthermore, Rodriguez argued that the decision of the Illinois courts rests upon the Illinois Constitution, which provides him greater protection than the fourth amendment.<sup>70</sup> Thus, because the decision of the Illinois courts rests upon adequate and independent state grounds, the Supreme Court should not review it.<sup>71</sup>

The issue of actual authority to consent was conceded by the State at oral argument.<sup>72</sup> Therefore, the Court essentially adopted the findings of the Illinois Appellate Court,<sup>73</sup> stating that “the Appellate Court’s determination of no common authority over the apartment was obviously correct.”<sup>74</sup> Two issues remained: (1) the question of jurisdiction and (2) the question of apparent authority.

### B. *The Question of Jurisdiction*

Citing *Michigan v. Long*,<sup>75</sup> Justice Scalia wrote that “[w]hen a state court decision is clearly based on state law that is both adequate and independent, we will not review the decision.”<sup>76</sup> He then stated, “[b]ut when a ‘state court decision fairly appears to rest primarily on federal law, or to be interwoven with federal law,’ we require that it contain a ‘plain statement’ that rests upon adequate and independent state grounds.”<sup>77</sup> Justice Scalia then quoted the *Long* Court stating,

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70. *Id.* at 2798.

71. *Id.*

72. Record at 3, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990) (No. 88-2018). Joseph Claps, First Assistant Attorney General of Illinois stated the issue before the Court as follows: “Illinois asks this Court to find that the court below committed error when it affirmed the trial court’s suppression of evidence by failing to recognize that a police officer’s reasonable reliance on a third party’s apparent authority to allow consensual entry is a valid exception to the warrant requirement.” *Id.* During the argument of James W. Reilley, Attorney for the Respondent, the following exchange occurred:

CHIEF JUSTICE REHNQUIST: Well, but I don’t —I don’t think that the — the petitioner is really contending that there was actual authority to consent. . . .

MR. REILLEY: Yes. So, all right. If the — if there—if they concede, which they obviously do. . . .

*Id.* at 38.

73. See Appendix II.

74. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2798 (1990).

75. 463 U.S. 1032 (1983). In *Long*, the Court admitted that “we have thus far not developed a satisfying and consistent approach for resolving this vexing issue [the question of independent and adequate state grounds].” *Id.* at 1038. The Court had taken a number of approaches, none of which had proven satisfactory to it. Therefore, in *Long*, the Court developed a clear, simple standard for independent and adequate state grounds, a standard that, if met, precluded review of a state court decision by the Supreme Court. *Id.* at 1040-41.

76. *Rodriguez*, 110 S. Ct. at 2798.

77. *Id.* (citing *Long*, 463 U.S. at 1040, 1042).

"[O]therwise, 'we will accept as the most reasonable explanation that the state court decided the case the way it did because it believed that federal law required it to do so.'"<sup>78</sup>

Rodriguez argued that while the Illinois Appellate Court clearly relied upon federal law in deciding the question of actual authority, "it is readily apparent that both the trial court and the Illinois Appellate Court considered only state law in turning aside the State's 'apparent authority' arguments."<sup>79</sup> Illinois courts insist that only actual authority can suffice for a consent search, a position deeply rooted in Illinois state constitutional law.<sup>80</sup> Thus, there is clearly a "'bona fide separate, adequate and independent' state law ground for the rulings in this case."<sup>81</sup> In citing the trial court record, Rodriguez stated there was "no doubt that the rulings of the Illinois courts rejecting the State's arguments regarding 'apparent authority' . . . have been based *exclusively* on . . . Illinois Supreme Court decisions."<sup>82</sup>

Rodriguez then argued that the appellate court also adhered to Illinois case law in rejecting the apparent authority argument presented by the State. Rodriguez quoted the appellate court as follows:

[W]e note that the trial court properly rejected the State's contention that Fisher [sic] had the apparent authority to consent. This conclusion is consistent with prior Illinois cases rejecting the argument that warrantless entries and searches may be upheld if the party who consented to the entry had apparent authority to do so but lacked actual authority.<sup>83</sup>

Rodriguez then argued, "Finally, and significantly, the Illinois Supreme Court declined to review the Appellate Court's decision notwithstanding

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78. *Id.* (citing *Long*, 463 U.S. at 1041).

79. Brief for Respondent at 17, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990) (No. 88-2018) [hereinafter Brief for Respondent].

80. *Id.*

81. *Id.* at 17-18.

82. *Id.* at 19 (emphasis in original). Respondent quoted the trial court record as follows:

I think I am obliged to follow the present situation in Illinois which would not allow for police to act on the apparent authority of the person in allowing the search of an apartment, the person in this case being Gayle [sic] Fischer. . . . It might change tomorrow.

The present state of the law does not allow for it and *Adams* [*People v. Adams*, 53 N.Y.2d 1, 422 N.E.2d 537, 439 N.Y.S.2d 877 (1981), cert. denied, 454 U.S. 854 (1981)] can only be instructive and I think can only really be acted on and adopted by a reviewing court and not by the trial court, given the fact that there are Illinois reviewing court opinions on the subject.

*Id.* at 19-20.

83. *Id.* at 20 (citing Joint Appendix, *supra* note 3, at 103). See Appendix II.

the State's request for the court to consider whether 'apparent authority' to consent would justify a search."<sup>84</sup> Rodriguez concluded, "Thus the record in this case shows a consistent application of *state* law requiring nothing less than actual common authority for consent to search."<sup>85</sup>

Rodriguez recognized that "the Illinois Appellate Court's opinion does not contain an explicit statement, per *Michigan v. Long*, that its rejection of any consideration of 'apparent authority' arguments is based exclusively on state law."<sup>86</sup> However, Rodriguez argued that such a statement is not necessary because "it is *impossible*" for the court's decision to rest on its interpretation of federal law.<sup>87</sup> Rodriguez noted that the court's opinion cites only a single federal case, *Matlock*, and argued that the court's discussion of *Matlock* is limited to the question of common authority to support a consent search.<sup>88</sup> Rodriguez argued that the Illinois courts could not have gained any guidance regarding the question of apparent authority from *Matlock* because "*Matlock* explicitly declines to address that question."<sup>89</sup>

The State argued that the Illinois Appellate Court clearly decided the case "solely under precedents from this [Supreme Court] and other courts applying the Fourth Amendment."<sup>90</sup> The State noted that the lower court opinion "did not cite any Illinois constitutional provision or statute, nor did it cite any case applying any Illinois constitutional provision or statute."<sup>91</sup> In addition, the "respondent [Rodriguez] never mentioned the Illinois Constitution in either the trial court or the Appellate Court."<sup>92</sup> The cases cited by the Illinois Appellate Court refer only to the fourth amendment.<sup>93</sup> None of these cases mention the Illinois Constitution.<sup>94</sup> The only precedent discussed at length or quoted in the Illinois Appellate Court opinion is *Matlock*.<sup>95</sup>

The State agreed that "*Matlock* did not resolve the precise issue in this case."<sup>96</sup> However, the State argued that "the fact that the Illinois

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84. *Id.*

85. *Id.*

86. *Id.*

87. *Id.*

88. *Id.* at 21.

89. *Id.* (citing *United States v. Matlock*, 415 U.S. 164, 177 n.14 (1974)) (emphasis in original).

90. Reply Brief for Petitioner at 16, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990) (No. 88-2018) [hereinafter Reply Brief for Petitioner].

91. *Id.* at 17.

92. *Id.*

93. *Id.*

94. *Id.* at 18.

95. *Id.* at 17.

96. *Id.* (citing *United States v. Matlock*, 415 U.S. 164, 177 n.14 (1974)).

Appellate Court announced that it was guided by . . . *Matlock* . . . and quoted extensively from it, establishes that this case was decided under the Fourth Amendment.”<sup>97</sup> The State argued that to succeed with his jurisdictional argument under *Michigan v. Long*, Rodriguez “must show some ‘plain statement’ by the lower court that it decided the case on the basis of state law.”<sup>98</sup> Rodriguez failed to do this because there is “no statement in the opinion . . . plain or otherwise,” that the case was decided on the basis of the Illinois Constitution or a statute or even “any precedent decided on state law grounds.”<sup>99</sup> The Court agreed with the State:

Here, the Appellate Court’s opinion contains no “plain statement” that its decision rests on state law. The opinion does not rely on (or even mention) any specific provision of the Illinois Constitution, nor even the Illinois Constitution generally. Even the Illinois cases cited by the opinion rely upon no constitutional provisions other than the Fourth and Fourteenth Amendments of the United States Constitution.<sup>100</sup>

The Court concluded that “the Appellate Court of Illinois rested its decision on federal law” and therefore, the Court had jurisdiction.<sup>101</sup>

### C. The Question of Apparent Authority

1. *The Participants.*—The question of “apparent authority to consent” attracted the interest of a number of parties not directly involved in the case. Consequently, the Court granted leave for amicus curiae briefs on behalf of both the State and Rodriguez. The Solicitor General of the United States, the Attorney General of California, and the Americans For Effective Law Enforcement, Inc.<sup>102</sup> filed on behalf of the State. The Assistant to the Solicitor General of the United States also participated in oral argument on behalf of the State by special leave of

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97. *Id.* at 17-18.

98. Reply Brief for Petitioner, *supra* note 90, at 19.

99. *Id.*

100. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2798 (1990).

101. *Id.*

102. Joined by: The International Association of Chiefs of Police, Inc., The Lincoln Legal Foundation, The National District Attorneys Association, Inc., The National Sheriff’s Association, Inc., The Chicago Crime Commission, and the Illinois Association of Chiefs of Police. Amici identified Gail Fischer as the wife of Edward Rodriguez. Brief of the Americans for Effective Law Enforcement, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990) (No. 88-2018). Consequently, the arguments presented by Amici discuss a case quite different from that of a girlfriend who had a key (e.g., “[T]he police belief that defendant’s wife had “common authority” over the premises was well grounded.”). *Id.*

the Court.<sup>103</sup> The National Association of Criminal Defense Lawyers filed on behalf of Rodriguez.

2. *Arguments by and on Behalf of the State.*—The State presented two arguments in support of its position: (1) that a search pursuant to consent given by one who reasonably appears to have actual authority to give consent, on the basis of the information known to the police at the time consent is given, is reasonable and thus constitutional and (2) “in the alternative, the good faith exception to the exclusionary rule should apply if the warrant requirement of the Fourth Amendment is not excused.”<sup>104</sup> Thus, the State requested the Court to create either another exception to the warrant requirement (reasonable reliance on apparent authority) of the fourth amendment or to extend the *Leon* “good faith” exception to third party consent searches.<sup>105</sup>

The State argued that the Court, in considering fourth amendment questions, had “been guided at all times by reasonableness.”<sup>106</sup> The State then quoted the Court in *United States v. Chadwick*,<sup>107</sup> in which the Court said, “Our fundamental inquiry concerning Fourth Amendment issues is whether or not a search or seizure is reasonable under all circumstances.”<sup>108</sup> “The test for apparent authority should be whether the police . . . reasonably believe that the third party possesses the requisite authority to consent.”<sup>109</sup> This test ignores the subjective beliefs of the officers, looking only to objective facts which the officers had available to them at the time consent was given.<sup>110</sup> This test makes the legality of all searches dependent on the facts and circumstances known at the time, not on facts determined much later in the clear view of hindsight.<sup>111</sup>

Such a position is consistent with the approach taken by the Court in *Hill v. California*<sup>112</sup> and *Maryland v. Garrison*.<sup>113</sup> “In *Hill*, the

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103. *Rodriguez*, 110 S. Ct. at 2796.

104. Reply Brief for Petitioner, *supra* note 90, at 1.

105. *See supra* note 22.

106. Reply Brief for Petitioner, *supra* note 90, at 1.

107. 433 U.S. 1 (1977).

108. Reply Brief for Petitioner, *supra* note 90, at 1 (quoting *Chadwick*, 433 U.S. at 9).

109. Brief for Petitioner, *supra* note 2, at 14.

110. *Id.*

111. Reply Brief for Petitioner, *supra* note 90, at 3.

112. 401 U.S. 797 (1971). In *Hill*, the police went to Hill’s apartment to arrest him. Miller answered the door. Miller matched the description of Hill, and the police arrested him, even though he produced identification. Evidence seized in the subsequent search incidental to the arrest was held admissible against Hill because the arrest was lawful, though mistaken. *Id.* at 804-05.

113. 480 U.S. 79 (1987). In *Garrison*, the police were executing a warrant search of an apartment when they unknowingly entered a second apartment. The physical layout of

officers mistakenly, but reasonably, arrested the wrong man.”<sup>114</sup> The Court held that the arrest was valid and evidence seized in a search incidental to the arrest was admissible against another party, *Hill*.<sup>115</sup> In *Garrison*, the police searched the wrong apartment in the mistaken belief that the apartment searched was the particular one described in a warrant. No warrant actually authorized the search conducted by the officers. Nevertheless, the Court “held that the search was justified by the reasonable belief of the officers that a warrant, which actually was for different premises, authorized the search.”<sup>116</sup>

The State noted that this Court had “ruled that the legality of a warrantless search of an automobile is to be determined by the facts known to the police at the time they searched the vehicle.”<sup>117</sup> This Court also ruled that a “stop and frisk” of a subject based upon a reasonable suspicion that the subject is engaged in a criminal activity is constitutional, based upon the facts known to the officer at the time of the “stop and frisk.”<sup>118</sup> Similarly, this Court held in *Maryland v. Buie*<sup>119</sup> that a warrantless “protective sweep” search, for the protection of police officers, is “justified by the apparent danger to the officers [at the time of the sweep] rather than by facts that later become known after the search.”<sup>120</sup> The State argued that “[t]hus, the general test applied under a recognized exception to the warrant requirement is that the legality of the search will be determined by the information known by the police at the time of the search, whether that information later turns out to be true or false.”<sup>121</sup>

Amicus Curiae United States agreed that “the principles announced in *Hill* and *Garrison* controlled in this case.”<sup>122</sup> “Under those principles, a search based on consent is justified when it is supported by a reasonable, but mistaken, belief that a consenting party is authorized to consent. . . .”<sup>123</sup> A search based upon consent does not require a “‘waiver’

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the building was such that the police had no way of knowing that they were in the wrong apartment.

114. Reply Brief for Petitioner, *supra* note 90, at 3.

115. *Id.*

116. *Id.* at 4.

117. *Id.* (citing *Michigan v. Long*, 463 U.S. 1032 (1983)). “In *Long*, the police saw a hunting knife in a car and then searched the car for additional weapons. There were no other weapons in the automobile, but some marijuana was found.” *Id.* The Court found the search to be constitutional.

118. *Id.* (citing *Terry v. Ohio*, 392 U.S. 1 (1968)).

119. 499 U.S. 325 (1990).

120. Brief for Petitioner, *supra* note 2, at 5.

121. *Id.*

122. Brief for the United States as Amicus Curiae Supporting Petitioner at 7, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990) (No. 88-2018).

123. *Id.*

of a person's fourth amendment rights; consent can validly be provided by a third-party.”<sup>124</sup>

The United States argued that apparent authority should be held sufficient for three reasons. “First, a rule requiring a showing of apparent authority adequately restricts the discretion of [the police] by requiring that they comply with objective, ascertainable rules.”<sup>125</sup> “Subjective good faith is not enough.”<sup>126</sup> Second, invalidating consent searches that at the time appeared reasonable would impose a substantial burden on all consent searches and would deter the police from “acting on consents that appear (and are) perfectly valid.”<sup>127</sup> Third, a strict requirement of actual authority is excessive and is more than “what is required to protect reasonable expectations of privacy.”<sup>128</sup> The United States then stated, “[T]o the extent that freedom from official invasion is safeguarded by the Fourth Amendment, that interest is qualified by the need for tolerance of reasonable mistakes in order to protect the ability of our police to discharge their mission.”<sup>129</sup>

The United States argued that an apparent authority rule would be consistent with the Court’s decision in *Stoner v. California*.<sup>130</sup> The police reliance on the consent of a hotel clerk was unreasonable because they were aware that the clerk was a clerk and that the room was rented by Stoner.<sup>131</sup> In addition, *Stoner* involved a mistake of law, not a mistake of fact, which does not come under the apparent authority concept.<sup>132</sup> That factor distinguishes *Stoner* from cases in which police “make a reasonable mistake of fact about a third-party’s apparent authority.”<sup>133</sup>

Amicus Curiae State of California stated the issue before the Court succinctly: “Does a police officer’s reasonable reliance upon a third party’s apparent authority to consent to an entry or search constitute ‘unreasonable’ conduct within the meaning of the Fourth Amendment, thereby invoking the exclusionary rule?”<sup>134</sup> In noting that the doctrine originated in a California case,<sup>135</sup> California stated that “a doctrine which

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124. *Id.* (citing *United States v. Matlock*, 415 U.S. 164 (1974)).

125. *Id.* (citing *Delaware v. Prouse*, 440 U.S. 648, 654 (1979)).

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.* at 16.

130. *Id.* at 18.

131. *Id.* at 18 nn.13 & 14.

132. *Id.* at 18-19 n.14.

133. *Id.* at 18-19.

134. Brief for the People of the State of California as Amicus Curiae, Question Presented, *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990) (No. 88-2018) [hereinafter Amicus Brief of California].

135. *People v. Gorg*, 291 P.2d 469, 473 (1955).

recognizes that mistakes made by policemen acting reasonably cannot be deterred by the exclusionary rule and may not fairly be characterized as ‘unreasonable’ conduct under the Fourth Amendment.”<sup>136</sup>

California argued that *Hill v. California*<sup>137</sup> and *Maryland v. Garrison*<sup>138</sup> “teach that a policeman’s reasonable mistake of fact is not ‘unreasonable’ conduct within the meaning of the Fourth Amendment.”<sup>139</sup> California then stated:

“The question whether the exclusionary rule’s remedy is appropriate in a particular context has long been regarded as an issue separate from the question whether the Fourth Amendment rights of the party seeking to invoke the rule were violated by police conduct.”

The Illinois court incorrectly resolved both questions. First, in holding that official reliance upon a third party’s consent given without actual authority automatically violates the Fourth Amendment, the court below focused exclusively on the existence of a constitutional right of privacy, without considering whether the police intrusion into protected privacy was “unreasonable” within the meaning of the Fourth Amendment. This approach forgets that “the Fourth Amendment does not proscribe all searches and seizures, but only those that are unreasonable.”

. . . Second, the state court suppressed evidence without considering the propriety of imposing the exclusionary rule, thereby ignoring the teaching of *United States v. Calandra*, that “[a]s with any remedial device, the application of the rule has been restricted to those areas where its remedial objectives are thought most efficaciously served.”<sup>140</sup>

California then argued that the Illinois courts also misinterpreted *Stoner*. “The actions of the police in *Stoner* were not constitutionally unreasonable because their mistake was one of law, rather than of fact; instead, their conduct was unreasonable in the tort law sense, i.e., it fell below the behavioral norm of a reasonably well trained officer.”<sup>141</sup> Amicus explained that “*Stoner* simply rejects an officer’s subjective good faith as an excuse for his *unreasonable* mistake of constitutional law.”<sup>142</sup>

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136. Amicus Brief of California, *supra* note 134, at 2.

137. 401 U.S. 797 (1971).

138. 480 U.S. 79 (1987).

139. Amicus Brief of California, *supra* note 134, at 3.

140. *Id.* at 4-5 (citations omitted).

141. *Id.* at 11.

142. *Id.* at 12.

California concluded by quoting the Court in *Michigan v. Tucker*<sup>143</sup> in which the Court stated, “The deterrent purpose of the exclusionary rule necessarily assumes that the police have engaged in willful, or at the very least, negligent conduct which has deprived the defendant of some right. . . . Where official action was pursued in complete good faith, however, the deterrence rationale loses much of its force.”<sup>144</sup> Therefore, a decision suppressing evidence may instruct police as to the law they must follow in the future, “but such a decision cannot alter their perception of facts in future cases” of similar nature.<sup>145</sup>

### 3. *Arguments by and on Behalf of Rodriguez.*

#### a. *Arguments presented by Rodriguez*

Rodriguez raised two arguments to support his position: (1) that Gail Fischer did not have “apparent authority” to consent to entry<sup>146</sup> and (2) that “the search cannot be justified on the ground that Gail Fisher [sic] appeared to have authority to consent in the eyes of the police.”<sup>147</sup> His first argument is based upon the law of agency. The second argument, as restated by the Court, is that “permitting a reasonable belief of common authority to validate an entry would cause a defendant’s Fourth Amendment rights to be ‘vicariously waived.’”<sup>148</sup>

##### i. *Agency relationship*

Rodriguez argued that the terms “apparent authority” to consent and “appearance of authority,” are not synonymous, contrary to their use by the State and the United States.<sup>149</sup> “[A]n agent cannot create apparent authority by his own representations; rather, apparent authority can only be created by the manifestations the principal makes to the third party.”<sup>150</sup> Rodriguez stated that “apparent authority” has been used in some decisions “because the third-party who consents to a search typically is a person with some type of formal relationship to the defendant — usually a spouse — which might be viewed as giving rise

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143. 417 U.S. 433, 447 (1974).

144. Amicus Brief of California, *supra* note 134, at 13 (citing *Tucker*, 417 U.S. at 447).

145. *Id.*

146. Brief for Respondent, *supra* note 79, at 22.

147. *Id.* at 25.

148. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2798 (1990).

149. Brief for Respondent, *supra* note 79, at 22.

150. *Id.* at 23 (citing RESTATEMENT (SECOND) OF AGENCY § 27 (1958)) (emphasis in original).

to a colorable agency relationship.”<sup>151</sup> Rodriguez quoted *Stoner v. California*<sup>152</sup> in which the Court stated that “[t]he rights protected by the Fourth Amendment are not to be eroded by strained applications of the law of agency or unrealistic doctrines of ‘apparent authority.’”<sup>153</sup>

Rodriguez noted that his case did not require the Court to “address the question of whether or how agency law applies to a third-party consent search.”<sup>154</sup> There was “absolutely no plausible agency relationship”<sup>155</sup> between the defendant and Gail Fischer. Rodriguez never represented to the police that Fischer was his agent nor “is there any marriage relationship from which even a ‘strained’ argument of an ‘agency’ relationship could conceivably be made.”<sup>156</sup> Thus, “the doctrine of apparent authority is totally inapplicable to this case.”<sup>157</sup>

### *ii. The question of waiver*

In addressing the issue of waiver, Rodriguez quoted Justice Stewart in *Stoner* where the Court said, “It is important to bear in mind that it was the petitioner’s constitutional right which was at stake, here, and not the night clerk’s nor the hotel’s. It was a right, therefore, which only the petitioner could waive by word or deed. . . .”<sup>158</sup> Rodriguez argued that the same consideration applies in his case because his “Fourth Amendment rights are at stake, not Gail Fischer’s.”<sup>159</sup> Only he had a legitimate expectation of privacy in the apartment; therefore, only he should be permitted to waive that privacy.<sup>160</sup> Rodriguez noted that the “Court has stressed the personal nature of Fourth Amendment rights,” quoting the Court in *Rakas v. Illinois*,<sup>161</sup> in which the Court held that “Fourth Amendment rights are personal rights which . . . may not be vicariously asserted.”<sup>162</sup> Rodriguez argued that “[i]t would be incongruous if rights that cannot be vicariously asserted can be vicariously waived.”<sup>163</sup> “The Fourth Amendment was written to protect the privacy interests

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151. *Id.*

152. 376 U.S. 483 (1964).

153. Brief for Respondent, *supra* note 79, at 23 n.15 (quoting *Stoner*, 376 U.S. at 488) (emphasis in original).

154. *Id.* at 24.

155. *Id.*

156. *Id.*

157. *Id.*

158. Brief for Respondent, *supra* note 79, at 31-32.

159. *Id.* at 32.

160. *Id.*

161. 439 U.S. 128 (1978).

162. Brief for Respondent, *supra* note 79, at 32 (quoting *Alderman v. United States*, 394 U.S. 165, 174 (1969)).

163. *Id.*

of individual citizens.”<sup>164</sup> Therefore, the reasonable expectations of privacy of citizens “are not protected when police fail to make reasonable inquiries into the validity of a third-party’s ‘consent’ to search.”<sup>165</sup>

In rebutting the arguments by the State and the United States, Rodriguez argued that their reliance on the “reasonable-factual-mistake approach set forth in *Maryland v. Garrison*<sup>166</sup> and *Hill v. California*”<sup>167</sup> was misplaced.<sup>168</sup> *Garrison* and *Hill* involved “genuine unavoidable factual errors made by police in the course of executing searches or arrests.”<sup>169</sup> In contrast, Rodriguez argued that his case “involved an unwarranted police decision to bypass constitutionally favored procedures<sup>170</sup> and conduct a . . . warrantless search on the basis of an obviously dubious ‘consent’ by a third-party known to be hostile to the resident of the apartment.”<sup>171</sup> Unlike the situation in *Garrison* and *Hill*, the police had three options to a warrantless search of the apartment and the seizure of Rodriguez: (1) they could have obtained an arrest warrant for Rodriguez based upon Gail Fischer’s complaint; (2) they could have obtained a search warrant for drugs based upon probable cause using Gail Fischer’s statements; and (3) they “could have simply knocked on the apartment door . . . and made a front-door arrest when [Rodriguez] answered”<sup>172</sup> as occurred in *Hill*. They instead chose to enter on the basis of a “dubious third-party ‘consent.’”<sup>173</sup> “In short, there is simply no comparison between the . . . factual errors in *Garrison* and *Hill* and the police decision in this case. . . .”<sup>174</sup>

Furthermore, “the need for the police to make reasonable efforts to inform themselves before accepting the validity of a third-party’s consent is particularly strong given the especially sensitive nature of third party consent issues.”<sup>175</sup> If there was indeed an error here, as opposed to outright bad faith, “the police clearly had the opportunity and the

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164. *Id.*

165. *Id.*

166. See *supra* note 113.

167. See *supra* note 112.

168. Brief for Respondent, *supra* note 79, at 25.

169. *Id.* (emphasis in original).

170. *Id.* at 26. Brief of Amicus Curiae, The National Association of Criminal Defense Lawyers, *Illinois v. Rodriguez* 110 S. Ct. 2793 (1990) [hereinafter Amicus Brief of Lawyers] (“one of the most venerable principles of fourth amendment law is that warrantless searches and seizures ‘are per se unreasonable . . . subject only to a few specifically established and well-delineated exceptions’”).

171. Brief for Respondent, *supra* note 79, at 26.

172. *Id.* at 26-27.

173. *Id.* at 27.

174. *Id.* at 28.

175. *Id.* at 31.

means to avoid it.”<sup>176</sup> A simple question such as ““Do you *currently* reside at this apartment’ is hardly burdensome” to the police and barely constitutes an “investigation” by the police.<sup>177</sup>

*b. Arguments presented by amicus*

Amicus National Association of Criminal Defense Lawyers (Lawyers) argued that accepting the concept of apparent authority in this case would be equal to creating “an ignorance is bliss exception,”<sup>178</sup> which was rejected by the Supreme Court of Oregon in *State v. Carsey*.<sup>179</sup> The Oregon Supreme Court stated that the fourth amendment “was not enacted for the primary purpose of encouraging police to act in good

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176. *Id.*

177. *Id.*

178. Amicus Brief of Lawyers, *supra* note 170, at 14 (quoting *State v. Carsey*, 295 Or. 32, 44, 664 P.2d 1085, 1094 (1983)). At oral argument, the Court asked whether the officers had asked Gail Fischer if she lived in the apartment at the time. Attorney for the State, Claps, conceded that they did not. The following exchange then occurred between the Court and Attorney Claps (Note: The Official Transcript does not identify the Justice asking questions. At numerous places it is easily determined who is speaking by Counsel’s response. In the following exchange, the Criminal Law Reporter (46 Cr. L. 3192, 3193) summary of oral argument identifies the Justices as Justice O’Connor followed by Justice Scalia. The hand annotated copy of the transcript provided to the writer notes that the questions were asked by Justice Scalia):

THE COURT: Do you think that under some apparent authority doctrine that there would be an obligation on the part of the police if there is any ambiguity present to ask appropriate questions to determine the basis of the person’s assumption of authority?

MR. CLAPS: We believe that the test should be an objective test of what the police officers knew and should have known in light of the facts and circumstances at the time. In this particular case —

THE COURT: Well, can they proceed on the assumption that ignorance is bliss or do they have some obligation to inquire?

MR. CLAPS: They have — they cannot proceed on the fact that ignorance is bliss. I think that’s primarily the ruling in *Stoner v. California*. You can’t ignore the fact that a person who is a motel clerk does not have the ability to gain — to give entry into an apartment. . . .

And so it was reasonable under the information given to the police, including the fact that most of her belongings were still in the apartment, that we don’t have in this case a situation where ignorance is bliss.

Record at 4-6.

THE COURT: So it’s just not what they know. It’s — it’s — they do have some positive obligation to make inquiry, don’t they?

MR. CLAPS: Yes, they do. . . . They have — you have to review in terms of what they knew or should have known in light of the facts and circumstances.

*Id.* at 7.

179. 295 Or. 32, 664 P.2d 1085 (1983).

faith. It was enacted to protect people in their homes against unreasonable, warrantless searches.”<sup>180</sup> The Lawyers stated:

Any decision fashioning an apparent authority doctrine will have disastrous consequences in police practice and the administration of justice. Once police obtain a colorable consent to search, they will have little incentive to conduct any further investigation to determine whether the person has actual authority. . . . Police will have little incentive to invoke the warrant procedure. Indeed, where probable cause is lacking or obtaining a warrant would be inconvenient, police would have substantial incentive to seek out someone lacking in actual authority but whose circumstances might provide them with the appearance of authority.<sup>181</sup>

They then argued that the extension of the *Leon* exception<sup>182</sup> to “the case of searches based on a police officer’s reasonable reliance on a third party’s apparent authority to consent must be rejected.”<sup>183</sup> The instant case is unlike *Leon* in which the police relied upon a warrant issued by a neutral and detached magistrate.<sup>184</sup> “[S]uppressing evidence seized based on an officer’s erroneous belief [in a third-party’s apparent authority] . . . will deter that officer and others from deciding to base a search on the consent of persons lacking [actual] authority.”<sup>185</sup>

The Lawyers concluded that the apparent authority doctrine fashioned by the State is a mirage that “purports to authorize searches for which no authority to search exists. It creates an illusion of reasonableness while permitting, and even encouraging, the very type of police misconduct the fourth amendment was intended to prevent.”<sup>186</sup> Adoption of an apparent authority exception or extending the *Leon* “good faith” exception to this scenario “would constitute an all too dangerous step toward elimination of the warrant requirement.”<sup>187</sup>

4. *The Decision of the Court.*—The Court did not address Rodriguez’s agency law argument because, as noted by the State, his argument was based upon a misinterpretation of *Stoner v. California*.<sup>188</sup> The State argued that *Stoner* dealt only with the question of actual authority and

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180. Amicus Brief of Lawyers, *supra* note 170, at 15 (quoting *Casey*, 295 Or. at 45, 664 P.2d at 1094).

181. *Id.* at 18-19.

182. See *supra* note 21.

183. Amicus Brief of Lawyers, *supra* note 170, at 21.

184. *Id.* at 20.

185. *Id.* at 21-22.

186. *Id.* at 23.

187. *Id.* at 24.

188. Reply Brief for Petitioner, *supra* note 90, at 7.

did not "decide or discuss the question of whether a search may be justified by consent from a person with apparent authority."<sup>189</sup> The Court apparently agreed with the State that Rodriguez's argument was misplaced and thus saw no need to address the issue.

In addressing Rodriguez's second argument, Justice Scalia wrote, "respondent asserts that permitting a reasonable belief of common authority to validate an entry [search] would cause a defendant's Fourth Amendment rights to be 'vicariously waived.' We disagree."<sup>190</sup> This Court would not permit evidence seized in violation of the fourth amendment to be admitted based solely on "a trial court's mere 'reasonable belief'—derived from statements by unauthorized persons—that the defendant has waived his objection."<sup>191</sup> However, "one must make a distinction between . . . trial rights that *derive* from the violation of constitutional guarantees and . . . the nature of those constitutional guarantees themselves."<sup>192</sup>

Justice Scalia then quoted the Court in *Schneckloth v. Bustamonte*:<sup>193</sup>

There is a vast difference between those rights that protect a fair criminal trial and the rights guaranteed under the Fourth Amendment. Nothing, either in the purposes behind requiring a "knowing" and "intelligent" waiver of trial rights, or in the practical application of such a requirement suggests that it ought to be extended to the constitutional guarantee against unreasonable searches and seizures.<sup>194</sup>

Justice Scalia further explained:

What Rodriguez is assured by the trial right of the exclusionary rule, where it applies, is that no evidence seized in violation of the Fourth Amendment will be introduced at his trial unless he consents. *What he is assured by the Fourth Amendment itself, however, is not that no government search of his house will occur unless he consents; but that no such search will occur that is "unreasonable."* U.S. Const. Amdt. 4. There are various elements, of course, that can make a search of a person's house

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189. *Id.* (citing 3 W. LAFAVE, SEARCH AND SEIZURE 262 n.96 (2d ed. 1987)).

190. *Illinois v. Rodriguez*, 110. S. Ct. 2793, 2798 (1990).

191. *Id.*

192. *Id.* (emphasis in original).

193. 412 U.S. 218 (1973).

194. *Rodriguez*, 110 S. Ct. at 2799 (citing *Schneckloth*, 412 U.S. at 241). The Court appeared to be differentiating between express trial rights (e.g., rights expressly granted under the fifth and sixth amendments), and rights which derive from a judicially created remedy (the exclusionary rule) of a violation of privacy under the fourth amendment.

“reasonable”—one of which is the consent of the person or his cotenant.<sup>195</sup>

Thus, Justice Scalia determined that “the essence of respondent’s argument is that we should impose on this element . . . [a] requirement that their [the officers] judgment [in regard to facts] be not only responsible but correct.”<sup>196</sup>

Justice Scalia explained that “the fundamental objective that alone validates all unconsented searches is . . . the seizure of persons who have committed or are about to commit crimes, or of evidence related to crimes.”<sup>197</sup> “But ‘reasonableness’ . . . does not demand that the government be factually correct.”<sup>198</sup> For example, “[w]arrants need only to be supported by ‘probable cause.’”<sup>199</sup> Another element often required to render an unconsented search “reasonable” is that the search be authorized by a valid warrant.<sup>200</sup> However, even here the Court has not held that “reasonableness” precludes errors of judgment in respect to factual issues,<sup>201</sup> as shown by *Garrison* in which the Court said, “[T]he validity of the search . . . depends on whether the officers’ failure to realize the overbreadth of the warrant was objectively understandable and reasonable. . . . The objective facts available to the officers at the time suggested no distinction between [the suspect’s] apartment and the third-floor premises.”<sup>202</sup> The warrant requirement is sometimes supplanted by other elements that render an unconsented search reasonable even when the person arrested is the wrong person.<sup>203</sup> To illustrate, Justice Scalia quoted the *Hill* Court:

[T]he officers in good faith believed that Miller was Hill and arrested him. They were quite wrong . . . and subjective good-faith would not in itself justify either the arrest or the subsequent search. But sufficient probability, not certainty, is the touchstone of the Fourth Amendment . . . the officers’ mistake was understandable and the arrest a reasonable response to the situation facing the officers at the time.<sup>204</sup>

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195. *Id.* (emphasis added).

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.* (citing *Illinois v. Gates*, 462 U.S. 213, 232 (1983)).

200. *Id.*

201. *Id.* (citing *Maryland v. Garrison*, 480 U.S. 79 (1987)).

202. *Id.*

203. *Id.* at 2799-2800 (discussing *Hill v. California*, 401 U.S. 797 (1971)). See *supra* note 112.

204. *Id.* at 2800.

Justice Scalia then wrote that “[i]t would be superfluous to multiply these examples. It is apparent that . . . to satisfy the ‘reasonableness’ requirement of the Fourth Amendment, what is generally demanded of the many factual determinations . . . made by agents of the government . . . is not that they always be correct, but that they always be reasonable.”<sup>205</sup> Thus, the Court saw

no reason to depart from this general rule with respect to facts bearing upon authority to consent to a search. Whether the basis for such authority exists is the sort of recurring factual question to which [police officers] must be expected to apply their judgment; and all the Fourth Amendment requires is that they answer it reasonably.<sup>206</sup>

Justice Scalia next addressed the language in *Stoner v. California*<sup>207</sup> that “the rights protected by the Fourth Amendment are not to be eroded . . . by unrealistic doctrines of ‘apparent authority.’”<sup>208</sup> Justice Scalia wrote:

It is ambiguous, of course, whether the word “unrealistic” is descriptive or limiting—that is, whether we were condemning as unrealistic all reliance upon apparent authority, or whether we were condemning only such reliance upon apparent authority as is realistic. Similarly ambiguous is the opinion’s earlier statement that “there [is no] substance to the claim that the search was reasonable because the police . . . had a reasonable basis for the belief that the clerk had authority to consent to a search.” Was there no substance to it because it failed as a matter of law, or because the facts could not possibly support it? . . .

“It is important to bear in mind that it was the petitioner’s constitutional right which was at stake here, and not the night clerk’s nor the hotel’s. It was a right, therefore, which only the petitioner could waive by word or deed, either directly or through an agent.” *Id.* But as we have discussed, what is at issue when a claim of apparent consent is raised is not whether the right to be free of searches has been *waived*, but whether the right to be free of *unreasonable* searches has been *violated*. . . . “But there is nothing in the record to indicate that *the police had any basis whatsoever to believe that* the night clerk had been

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205. *Id.*

206. *Id.*

207. 376 U.S. 483 (1964).

208. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2800 (1990) (citing *Stoner*, 376 U.S. at 488).

authorized by the petitioner to permit the police to search the petitioner's room."

The italicized language should have been deleted, of course, . . . if the statement . . . meant that an appearance of authority could never validate a search.<sup>209</sup>

Thus, Justice Scalia determined that "the rationale of *Stoner* was ambiguous—perhaps deliberately so."<sup>210</sup> It is a reasonable reading of *Stoner*, perhaps a preferable one, that the police could not rely upon the consent of the hotel clerk because they knew he was a clerk, and they knew that the room was rented by Stoner.<sup>211</sup> The police "could not reasonably have believed that the [clerk] had general access or control over [Stoner's room]."<sup>212</sup> Therefore, the Court was correct in *Matlock* when it regarded the present issue as unresolved.<sup>213</sup>

In conclusion, Justice Scalia stated that as *Stoner* demonstrates, the decision in this case does not mean that police officers may always accept a person's invitation to enter.<sup>214</sup> Even if such an invitation is accompanied by an explicit statement that the person lives there, the facts and circumstances facing the officers could conceivably be that a reasonable person would doubt the statement and not act without further inquiry.<sup>215</sup> "As with other factual determinations bearing upon search and seizure, determination of consent to enter [search] must be judged against an objective standard. . . ."<sup>216</sup> The standard is "would the facts available to the officer at the moment . . . 'warrant a man of reasonable caution in the belief' that the consenting party had authority over the premises?"<sup>217</sup> "If not, then warrantless entry without further inquiry is unlawful unless authority actually exists. But if so, the search is valid."<sup>218</sup>

The Court noted that the Illinois Appellate Court "found it unnecessary to determine [if] the officers reasonably believed Fischer had the authority to consent [to their entry] because it ruled as a matter of law that a reasonable belief could not validate the entry."<sup>219</sup> Therefore, the Court remanded to the trial court for consideration of that question.<sup>220</sup>

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209. *Id.* at 2800-01 (emphasis in original) (citations omitted).

210. *Id.* at 2801.

211. *Id.*

212. *Id.*

213. See *id.*

214. *Id.*

215. *Id.*

216. *Id.*

217. *Id.* (citing *Terry v. Ohio*, 392 U.S. 1, 21-22 (1968)).

218. *Id.*

219. *Id.*

220. *Id.*

5. *The Dissent.*—Justice Marshall, joined by Justice Brennan and Justice Stevens, dissented. Justice Marshall argued that the majority's position is based upon "a misconception of the [legal] basis for third-party consent searches."<sup>221</sup> Such searches are not unconstitutional because they are "reasonable," but "a person may voluntarily limit his expectation of privacy."<sup>222</sup> "If a [person] has not so limited his expectation of privacy, the police may not dispense with the safeguards [of] the Fourth Amendment."<sup>223</sup> "The baseline for the reasonableness of a search or seizure in the home is the presence of a warrant."<sup>224</sup> This Court has "further held that a 'search or seizure carried out on a suspect's premises without a warrant is *per se* unreasonable, unless . . . it falls within one of a carefully defined set of exceptions.'"<sup>225</sup>

Justice Marshall stated that the Court only allowed exceptions to the warrant requirement under exigent circumstances, that is, the safety of the police or of citizens.<sup>226</sup> The Court has rejected exceptions to the warrant requirement because of the burdens on police investigation and criminal prosecutions.<sup>227</sup> This is due to the Court's firm commitment that the privacy of one's home should not be sacrificed to the interest of efficiency in law enforcement.<sup>228</sup> Therefore, "[i]n the absence of an exigency . . . warrantless home searches and seizures are unreasonable under the Fourth Amendment."<sup>229</sup> Third party consent searches are not based upon an exigency; therefore, when the police are faced with the choice of relying on a third party's consent or securing a warrant, they should secure a warrant, or accept the risk of error if they choose to rely on consent.<sup>230</sup>

Justice Marshall argued that the cases cited by the majority "provide no support for its holding."<sup>231</sup> *Brinegar v. United States*<sup>232</sup> only confirmed the "unremarkable proposition that police only need probable cause, not absolute certainty."<sup>233</sup> In *Maryland v. Garrison*, the police had

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221. *Id.* at 2802 (Marshall, J., dissenting).

222. *Id.*

223. *Id.*

224. *Id.* (citing *Skinner v. Railway Labor Executives' Ass'n.*, 109 S. Ct. 1402 (1989)). See *Payton v. New York*, 445 U.S. 573 (1980) (zone of privacy is nowhere more clearly defined than when it is bounded by the dimensions of an individual's home).

225. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2803 (1990) (citing *Coolidge v. New Hampshire*, 403 U.S. 443, 474 (1971)).

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.* at 2804.

231. *Id.* at 2805.

232. 338 U.S. 160 (1949).

233. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2805 (1990)

obtained a valid warrant. "Because searches based upon warrants are generally reasonable, the officers' reasonable mistake of fact did not render their search 'unreasonable.'"<sup>234</sup> Thus, the "majority's glib assertion that '[i]t would be superfluous to multiply' its citations" to such cases is correct, but not for the reason given by the majority.<sup>235</sup> "Those cases provide no illumination of the issues raised in this case, and further citation to like cases would be as superfluous as the discussion upon which the majority's conclusion presently depends."<sup>236</sup> Justice Marshall concluded:

Instead of judging the validity of consent searches, as we have in the past, based on whether a defendant has in fact limited his expectation of privacy, the Court today carves out an additional exception to the warrant requirement for third party consent searches. . . . Where this free floating creation of "reasonable" exceptions to the warrant requirement will end, now that the Court has departed from the balancing approach that has long been part of our Fourth Amendment jurisprudence, is unclear. But by allowing a person to be subjected to a warrantless search in his home without his consent and without exigency, the majority has taken away some of the liberty that the Fourth Amendment was designed to protect.<sup>237</sup>

Justice Scalia addressed Justice Marshall's dissent in a footnote. Justice Scalia said:

Justice Marshall's dissent rests upon a rejection of the proposition that searches pursuant to valid third-party consent are "generally reasonable." . . . Only a warrant or exigent circumstances, he contends, can produce "reasonableness"; consent validates the search only because the object of the search thereby "limit[s] his expectation of privacy," . . . so that the search becomes not really a search at all. We see no basis for making such an artificial distinction. To describe a consented search as a non-invasion of privacy and thus a non-search is strange in the extreme. And while it must be admitted that this ingenious device can explain why consented searches are lawful, it cannot explain why seemingly consented searches are "unreasonable," which is all that the Constitution forbids.<sup>238</sup>

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234. *Id.* at 2806.

235. *Id.*

236. *Id.*

237. *Id.* at 2806-07.

238. *Id.* at 2800, n.\*.

Justice Scalia then stated that "the only basis for contending that the constitutional standard could not possibly have been met here is the argument that reasonableness must be judged by the facts as they were, rather than the facts as they were known."<sup>239</sup> Such a hindsight "argument has long since been rejected."<sup>240</sup>

### III. WHITHER THE FOURTH AMENDMENT

#### A. Analysis

Contrary to Justice Marshall's statement, the Court did not create "an additional exception to the warrant requirement for third-party consent searches."<sup>241</sup> The Court was invited to create either another exception to the warrant requirement, an "apparent authority exception," or to extend the *Leon* "good faith" exception to encompass third party apparent authority to consent.<sup>242</sup> However, the majority did not do so, instead presenting the sweeping "reasonable" test for all fourth amendment questions. Nowhere in the opinion does Justice Scalia limit the "reasonable" test to the question of consent searches, third party consent, or to apparent authority. Nor does Justice Scalia even mention *Leon* or a "good faith" exception. Throughout the opinion he refers to the word "unreasonable" as used in the fourth amendment.

It appears that Justice Scalia recognized that fourth amendment jurisprudence has created more exceptions to the warrant requirement than there are words in the fourth amendment itself.<sup>243</sup> In a manner of speaking, all exceptions to the warrant requirement have a common nexus; either society finds the conduct of the police reasonable or society finds the conduct of the defendant unreasonable. Searches under exigent circumstances are accepted by society as reasonable to protect the police, the community, or both. On the other hand, if something is left in plain sight, society finds it unreasonable to protect an interest that the defendant himself has shown no desire to protect. A person expects that telephone calls made from an enclosed public phone are private; thus, it is unreasonable for the police to invade that privacy.<sup>244</sup> Is it reasonable for a police officer to believe that a hotel clerk can allow the search of an occupied room? Obviously not, as *Stoner* so states. Is it reasonable for the police to rely on a warrant that is valid

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239. *Id.*

240. *Id.*

241. *Id.* at 2806 (Marshall, J., dissenting).

242. See *supra* text accompanying notes 104-45.

243. See *supra* note 27.

244. E.g., *Katz v. United States*, 389 U.S. 347 (1967).

on its face? Obviously it is, as *Leon* illustrates. In other words, to answer Justice Marshall, it is not a matter of where this reasonableness test will lead us; it is an explanation of how we got to where we are today.

Justice Scalia also answered the "question of law" or "question of fact" issue.<sup>245</sup> He clearly stated that determinations of consent are factual questions.<sup>246</sup> He also stated that "as with other factual determinations bearing upon search and seizure, determinations of consent to enter must be judged by an objective standard."<sup>247</sup> This statement, of course, implies that all fourth amendment determinations bearing upon the validity of a warrantless search or seizure under the "reasonable" test are factual determinations. Thus, they are the province of the trial court and will only be overruled if "clearly erroneous."<sup>248</sup> Therefore, it appears that Justice Scalia has attempted a simplification of fourth amendment jurisprudence. It is no longer a matter of what exception applies or if there is an applicable exception to the warrant requirement, it is a matter of determining the reasonableness of the behavior of the police under the facts of the case at the time of the police action. Such a determination is a question of fact and is to be determined by the finder of fact; in the case of an evidentiary question, the determiner of law is also the finder of fact, the trial judge.

Whether we agree with this decision or not is immaterial. What is important is that the Court decided this case 6-3. With the retirement of Justice Brennan and the elevation of Justices Souter and Thomas to the Court, it is likely that a similar case will result in a similar vote, even as great as an 8-1 vote. Thus, it is likely that *Rodriguez* will be fourth amendment precedent for the foreseeable future. Therefore, in addressing future fourth amendment cases, it is wise to remember the words of Justice Jackson: "We are not final because we are infallible, but we are infallible only because we are final."<sup>249</sup> The Court may not be always right, but in questions of federal constitutional law, it is always final.

#### B. A Suggested Approach For Defense Counsels

As confirmed by *Rodriguez*, "whether or not a violation of the Fourth Amendment occurs [is] a matter of federal constitutional law, and a state court [may] not substitute its own judgment on this matter

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245. See *supra* notes 57-67 and accompanying text.

246. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2800 (1990).

247. *Id.* at 2801.

248. See *supra* note 63.

249. *Brown v. Allen*, 344 U.S. 443, 540 (1953).

for that of the Supreme Court.”<sup>250</sup> In state criminal actions, the prosecution will prefer to rely on decisions such as *Rodriguez* on questions regarding the admissibility of evidence. The defense will most likely prefer a higher standard.

State courts are free to adopt, under state law, exclusionary sanctions for violations of state constitutional, statutory, and even administrative law.<sup>251</sup> “Where this is done, both the decision as to whether a violation of the underlying requirement has occurred and as to whether exclusions of resulting evidence is required are matters of state law, not subject to review by the Supreme Court.”<sup>252</sup> Most states have state constitutional provisions similar to the fourth amendment of the United States Constitution.<sup>253</sup> “In those few states lacking a state equivalent of the Fourth Amendment, other state constitutional language may provide a basis for finding protected rights similar to those protected by the Fourth Amendment.”<sup>254</sup>

Justice Scalia carefully analyzed the jurisdictional question raised by *Rodriguez*, even though the lower court opinion is unpublished. He set forth the standard for review of a state court decision by the Supreme Court as established in *Michigan v. Long*.<sup>255</sup> “[W]e require that it contain a ‘plain statement’ that rests upon adequate and independent state grounds.”<sup>256</sup> The *Long* Court stated that “[w]e believe that such an approach will provide state judges with a clearer opportunity to develop state jurisprudence unimpeded by federal interference.”<sup>257</sup> The *Long* Court then quoted *Minnesota v. National Tea Co.*,<sup>258</sup> in which it stated, “It is fundamental that state courts be left free and unfettered by us in interpreting their state constitutions.”<sup>259</sup> This is the final lesson of *Rodriguez*. It appears that the Court is saying: “Defense Counsel: Your state constitution probably gives your client more protection than the Fourth Amendment. We are a national, minimum standard (and not a very high one at that). Base your

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250. E.W. CLEARY, MCCORMICK ON EVIDENCE 452 (3d ed. 1984).

251. *Id.*

252. *Id.*

253. *Id. See, e.g., ALASKA CONST. art. I, § 14; CAL. CONST. art. 1, § 19; ILL. CONST. art. 1, § 6; IND. CONST. art. 1, § 11; ME. CONST. art. I, § 5; N.J. CONST. art. 1, par. 7; N.Y. CONST. art. 1, § 12; PA. CONST. art. 1, § 8; TEX. CONST., art. 1, § 9.* See also E.W. CLEARY, *supra* note 250, at 4562 n.24.

254. *See* E.W. CLEARY, *supra* note 250, at 452 n.24.

255. *See supra* note 75.

256. *Illinois v. Rodriguez*, 110 S. Ct. 2793, 2798 (1990).

257. *Long*, 463 U.S. at 1041.

258. 309 U.S. 551 (1934).

259. *Long*, 463 U.S. at 1041 (citing *National Tea Co.*, 309 U.S. at 557).

arguments on adequate and independent state grounds and we will not review it.”

The Court seems to return to federalism which is consistent with the approach in *Webster v. Reproductive Health Services*.<sup>260</sup> In *Webster*, the Court appeared to say that some questions regarding abortion are best handled by the states. The Constitution and Bill of Rights do not expressly recognize a right of privacy. Some states do.<sup>261</sup> Thus, this writer believes that the Court is saying that rights of privacy protected by the fourth amendment are questions best handled by the states.<sup>262</sup> The Court has set a national, uniform minimum standard. The states may not go below this standard, but they are free to grant more protection to their citizens than the federal Bill of Rights. Because the majority of criminal actions are brought by the states in state courts, perhaps questions of criminal law that relate to an individual’s right of privacy are best handled by the states. There is no guarantee that state courts will grant more protection than the federal constitution, but at least it is clear that the states cannot grant less than the federal constitution.

A hornbook example of how a state decision should be written so that it will “rest on upon adequate and independent state grounds” was provided by the Indiana Supreme Court in 1922, fully sixty-one years prior to *Michigan v. Long*. In *Callender v. State*,<sup>263</sup> thirty-eight years before *Mapp v. Ohio*,<sup>264</sup> the Indiana Supreme Court adopted the exclusionary rule, prohibiting evidence seized in violation of Article 1, section 11 of the Indiana Constitution. Judge Willoughby, writing for a unanimous court and relying solely on Article 1, section 11<sup>265</sup> and section

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260. 492 U.S. 490 (1989).

261. In 1980, Florida voters amended the state constitution to provide: “Every natural person has the right to be let alone and free from government intrusion into his private life except as otherwise provided herein. This section shall not be construed to limit the public’s right of access to public records and meetings. . . .” FLA. CONST. art. I, § 23. Alaska, California, and Montana also have express state constitutional provisions guaranteeing an independent right to privacy.

262. In *Katz v. United States*, the Court stated: “But the protection of a person’s general right to privacy—his right to be let alone by other people—is, like the *protection of his property* and of his very life, left largely to the law of the individual states.” *Katz v. United States*, 389 U.S. 347, 350-51 (1967) (emphasis added). Thus the states, not the federal government, are the final guarantors of personal privacy.

263. 193 Ind. 91, 138 N.E. 817 (1923).

264. 367 U.S. 643 (1961).

265. “The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable search, or seizure, shall not be violated; and no warrant shall issue, but upon probable cause, supported by oath or affirmation, and particularly describing the place to be searched, and the person or thing to be seized.” IND. CONST. art. I, § 11. It is apparent that what is important is the meaning given these words by the Indiana Supreme Court, not the actual words themselves.

14<sup>266</sup> of the Indiana Constitution said:

If the property was secured by search and seizure under the pretext of a search warrant, which was invalid for any reason, then the property so seized could not be used as evidence against the appellant and its admission over his objection was prejudicial error. . . .<sup>267</sup>

There being no evidence to support the verdict except that procured by the illegal search warrant, and improperly admitted, it is not supported by sufficient evidence and is contrary to law. The judgment is reversed. . . .<sup>268</sup>

In discussing the above statement from *Callender*, Chief Justice Randall T. Shepard of the Indiana Supreme Court wrote the following: “[T]hese words were written nearly forty years before *Mapp v. Ohio*, at a time when the exclusionary rule was so unpopular that Professor Wigmore was moved to call it revolutionary and against all rules of evidence theretofore pertaining to the subject.”<sup>269</sup> Turning to the Indiana Constitution, Chief Justice Shepard said that “the Indiana Constitution provides a great variety of protections for citizens which are not contained in the Federal Bill of Rights. . . . [T]here are a great many parts of Indiana’s Bill of Rights which simply have no federal counterpart.”<sup>270</sup> However, the ability of the Court to apply the Indiana Constitution effectively depends upon the ability of the attorneys who appear before it.<sup>271</sup> “The Indiana Supreme Court has signaled twice this year [1988] that we will not take Indiana constitutional claims to be serious ones when litigants themselves treat them lightly.”<sup>272</sup> “In short, our ability to make good law frequently depends on counsel, and I solicit your help.”<sup>273</sup>

Chief Justice Shepard concluded with the following:

The rights of Americans cannot be secure if they are protected only by courts or only by one court. Civil liberties protected only by a U.S. Supreme Court are only as secure as the Warren Court or the Rehnquist Court wishes to make them. The pro-

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266. “No person shall be put in jeopardy twice for the same offense. No person, in any criminal prosecution, shall be compelled to testify against himself.” IND. CONST. art. I, § 14.

267. *Callender*, 193 Ind. at 96, 138 N.E. at 818.

268. *Id.* at 99, 138 N.E. at 819.

269. Shepard, *Second Wind for the Indiana Bill of Rights*, 22 IND. L. REV. 575, 578 (1989) (citing J. WIGMORE, EVIDENCE, §§ 2183-84 (2d ed. 1923)).

270. *Id.* at 580.

271. *Id.* at 584.

272. *Id.*

273. *Id.* at 585.

tection of Americans against tyranny requires that state supreme courts and state constitutions be strong centers of authority on the rights of the people. I am determined that the Indiana Constitution and the Indiana Supreme Court be strong protectors of those rights.<sup>274</sup>

There are forty-nine other state supreme courts. This writer firmly believes that the sentiments expressed by Chief Justice Shepard are not unique to the Indiana Supreme Court. However, as Chief Justice Shepard stated, a state supreme court's "ability to make good law frequently depends on counsel."<sup>275</sup> It is up to us, the lawyers, to make the arguments in such a manner that the rights guaranteed by our state constitutions benefit our clients to the fullest extent possible.

In *Rodriguez* and in *Long*, the Court has shown us what is required by the U.S. Supreme Court. Chief Justice Shepard has told us that the state supreme courts are prepared to answer the challenge. It is now up to us, the lawyers, to provide the quality arguments which will enable our state supreme courts to answer the challenges that face the civil liberties of our nation today.

FRANK C. CAPOZZA\*

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274. *Id.* at 586.

275. *Id.* at 585.

\* B.S., 1964, St. Lawrence Univ.; M.A., 1967, Indiana Univ.; J.D., December, 1991, Indiana University—Indianapolis.

## APPENDIX I

The following is the Introduction, Statement of Facts, and Statement of the Case of *Illinois v. Rodriguez*, 110 S. Ct. 2793 (1990).

Justice SCALIA delivered the opinion of the Court.

In *United States v. Matlock*, 415 U.S. 164, 94 S. Ct. 988, 39 L. Ed. 2d 242 (1974), this Court reaffirmed that a warrantless entry and search by law enforcement officers does not violate the Fourth Amendment's proscription of "unreasonable searches and seizures" if the officers have obtained the consent of a third party who possesses common authority over the premises. The present case presents an issue we expressly reserved in *Matlock*, see *Id.*, at 177, n. 14, 94 S. Ct. at 996: whether a warrantless entry is valid when based upon the consent of a third party whom the police, at the time of the entry, reasonably believe to possess common authority over the premises, but who in fact does not do so.

Respondent Edward Rodriguez was arrested in his apartment by law enforcement officers and charged with possession of illegal drugs. The police gained entry to the apartment with the consent and assistance of Gail Fischer, who had lived there with respondent for several months. The relevant facts leading to the arrest are as follows.

On July 26, 1985, police were summoned to the residence of Dorothy Jackson on South Wolcott in Chicago. They were met by Ms. Jackson's daughter, Gail Fischer, who showed signs of a severe beating. She told the officers that she had been assaulted by respondent Edward Rodriguez earlier that day in an apartment on South California. Fischer stated that Rodriguez was then asleep in the apartment, and she consented to travel there with the police in order to unlock the door with her key so that the officers could enter and arrest him. During this conversation, Fischer several times referred to the apartment on South California as "our" apartment, and said that she had clothes and furniture there. It is unclear whether she indicated that she currently lived at the apartment, or only that she used to live there.

The police officers drove to the apartment on South California, accompanied by Fischer. They did not obtain an arrest warrant for Rodriguez, nor did they seek a search warrant for the apartment. At the apartment, Fischer unlocked the door with her key and gave the officers permission to enter. They moved through the door into the living room, where they observed in plain view drug paraphernalia and containers filled with white powder that they believed (correctly, as later analysis showed) to be cocaine. They proceeded to the bedroom, where they found Rodriguez asleep and discovered additional containers of white powder in two open attache cases. The officers arrested Rodriguez and seized the drugs and related paraphernalia.

Rodriguez was charged with possession of a controlled substance with intent to deliver. He moved to suppress all evidence seized at the time of his arrest, claiming that Fischer had vacated the apartment several weeks earlier and had no authority to consent to the entry. The Cook County Circuit Court granted the motion, holding that at the time she consented to the entry Fischer did not have common authority over the apartment. The Court concluded that Fischer was not a "usual resident" but rather an "infrequent visitor" at the apartment on South California, based upon its findings that Fischer's name was not on the lease, that she did not contribute to the rent, that she was not allowed to invite others to the apartment on her own, that she did not have access to the apartment when respondent was away, and that she had moved some of her possessions from the apartment. The Circuit Court also rejected the State's contention that, even if Fischer did not possess common authority over the premises, there was no Fourth Amendment violation if the police *reasonably believed* at the time of their entry that Fischer possessed the authority to consent.

The Appellate Court of Illinois affirmed the Circuit Court in all respects. The Illinois Supreme Court denied the State's Petition for Leave to Appeal, 125 Ill. 2d 572, 130 Ill. Dec. 487, 537 N.E.2d 816 (1989), and we granted certiorari. 493 U.S. 110 S. Ct. 320, 107 L. Ed. 2d 311 (1989).

## APPENDIX II

The following is from the Joint Appendix filed with the United States Supreme Court by Counsel for Petitioner and Counsel for Respondent.

**IN THE  
APPELLATE COURT OF ILLINOIS  
FIRST JUDICIAL DISTRICT**

**THE PEOPLE OF THE STATE OF ILLINOIS,**

Plaintiff-Appellant,  
**EDWARD RODRIGUEZ,**  
Defendant-Appellee.

**ORDER**

The defendant, Edward Rodriguez, was arrested on July 26, 1985, and charged with possession of a controlled substance with the intent to deliver. He was charged on the basis of certain items of physical evidence seized during a warrantless search of his apartment that was conducted pursuant to the consent of a third-party. The trial court granted defendant's motion to quash his arrest and suppress evidence, holding that the party who consented to the entry into defendant's apartment was without authority to do so. The State appeals from this order questioning whether consent to enter was properly given.

The trial court heard defendant's motion to suppress evidence on the grounds that the party who consented did not have the authority to consent because she was not living at defendant's apartment at the time that she consented to the entry. At the hearing, Officer James Entress testified that on July 26, 1985, at about 2:30 p.m. he and his partner, Officer Ricky Gutierrez, received a call from Officer Tenza asking for assistance at a residence located at 3554 South Wolcott. Upon arriving, Officer Entress had a conversation with Gale Fisher. Also present during this conversation were Officer Tenza, Officer Gutierrez, and Dorothy Jackson (Fisher's mother). Fisher told Officer Entress that earlier in the day defendant had beaten her at their apartment at 3519 South California and that she wanted to make a complaint. She also indicated that she had been living at that apartment, that her clothes and furniture were in that apartment, that defendant was presently asleep there, and that she had a key to the apartment and would let the officers enter to arrest defendant.

During direct examination, Officer Entrees acknowledged that he had testified at a preliminary hearing that Fisher had told him that she used to live at the apartment on South California. However, he went on to say that it was his impression that she was still living there at the time she agreed to let them into the apartment. Officer Entress testified that during his conversation with Fisher he told her that they

would only arrest the defendant if Fisher was certain that she wanted to press charges against him, and that she seemed hesitant about signing a complaint. Having recalled a conversation with someone a year earlier concerning the involvement of an individual named Edward Rodriguez with narcotics, Officer Entress asked Fisher if defendant was involved with narcotics and Fisher would not respond to that question.

Officer Entress testified that he, Officer Gutierrez, Fisher, and her mother proceeded to the apartment on South California. Fisher opened the door with her key and allowed the officers to enter. Officer Entress first entered the living room where he observed containers of a substance he believed to be cocaine and drug paraphernalia including pipes and scales. He then proceeded to the bedroom where he observed defendant sleeping on a bed. In the course of waking defendant, Officer Entress saw two open briefcases at the side of the bed that contained a white substance that he believed to be cocaine. Defendant was subsequently arrested. On cross-examination, Officer Entress testified that Fisher used the term "our" and "their" when referring to the apartment on South California.

Dorothy Jackson testified that on July 1, 1985, she drove her daughter to the apartment on South California at the latter's request so that she could remove her clothes from the apartment. She removed several bags of clothing and left behind her stove, refrigerator and some furniture. Ms. Jackson testified that her daughter told her that she was staying with her because defendant wanted one of their two children toilet trained. She stated that since there was no agreement that Fisher and the children would stay with the witness, Fisher would have to return to her apartment on South California after the child was trained. According to Ms. Jackson, her daughter and her children stayed with Jackson from July 1 through July 26, 1985. During that time Fisher visited defendant and, on approximately two or three occasions, spent the night at his apartment. She also stated that the apartment on South California was Ms. Fisher's home. In the afternoon of July 26, Fisher went to Ms. Jackson's house and told her that defendant had beaten her, whereupon Ms. Jackson telephoned the police and Officer Tenza arrived a few minutes later.

Fisher testified that she lived with defendant at the apartment on South California from December 1984 through June 1985, and that she moved in with her mother on July 1, 1985. When she moved in with her mother, she left the key at defendant's apartment. She stated that she did not have a key to defendant's apartment from July 1 to July 26 and that defendant would let her into the apartment when she went to visit him during that time. She did take a key from defendant's dresser on July 26, after she and defendant had argued. During July 1985 she never had any friends at the apartment on South California,

she only went there to visit defendant, and she never went there when defendant was not in the apartment. According to Fisher, she did not remove her stove, refrigerator and furniture that her name was not on lease and that defendant always paid the rent on the apartment. Fisher stated that although she did tell Officer Entress that she had a key to the apartment and agreed to let him inside, she also indicated that she did so because the police told her that is what she had to do if she wanted to press charges. She denied telling Officer Entress on July 26 that she was living in the apartment on South California.

Our review of the trial court's decision to grant defendant's motion to suppress, recognizes that its ruling will not be set aside unless clearly erroneous. (*People v. White* (1987), 117 Ill. 2d 194, 512 N.E.2d 677). We note at the outset that this case involves a consent to enter and not a consent to search, and that case law regarding third party consent commonly involves consent to search. However, the concept of consent to search is fundamentally intertwined with the concept of consent to enter since the validity of a warrantless seizure of evidence in plain view depends on the validity of the entry by the officers seizing the evidence. Therefore, the application of that case law to the instant case is both proper and relevant.

In determining whether Fisher had the authority to consent to the warrantless search of defendant's apartment, we are guided by the rule set forth in *United States v. Matlock*, (1974), 415 U.S. 164, 171, 39 L. Ed. 2d 242, 94 S. Ct. 988, which involved a consent to search. In that case, the United States Supreme Court ruled that "when the prosecution seeks to justify a warrantless search by proof of voluntary consent, it is not limited to proof that consent was given by the defendant, but may show that permission to search was obtained from a third party who possessed common authority over or other significant relationship to the premises or effect sought to be inspected." The Supreme Court explained the term "common authority" as follows:

"Common authority is, of course, not to be implied from the mere property interest a third party has in the property. The authority which justifies the third-party consent does not rest upon the law of property, . . . but rests rather on mutual use of the property by persons generally having joint access or control for most purposes, so that it is reasonable to recognize that any of the co-inhabitants has the right to permit the inspection in his own right and that the others have assumed that risk that one of their number might permit the common area to be searched." *United States v. Matlock*, (1974), 415 U.S. 164, 171, n.7.

The Illinois Supreme Court adopted this common authority doctrine for cases involving third-party consent in *People v. Stacey* (1974), 58 Ill. 2d 83, 317 N.E.2d 24. In that case the defendant's wife who was jointly occupying a house with the defendant, allowed police to remove

a shirt from defendant's dresser drawer that was located in their bedroom. The court concluded that the mere fact that the defendant alone may have used a dresser drawer while his wife may have used another did not indicate that the wife was denied the mutual use, access to or control of the drawer.

The application of this doctrine requires a determination as to whether the consenting party had sufficient common authority to consent to the entry of the premises where the evidence was found in plain view. (*People v. Callaway*, (1988), 167 Ill. App. 3d 872, 522 N.E.2d 337); (*People v. Posey* (1981), 99 Ill. App. 3d 943, 426 N.E.2d 209.) The third-party consent to enter must be made from a person who has control over the premises. (*People v. Daugherty* (1987), 161 Ill. App. 3d 394, 514 N.E.2d 228.)

In reviewing the record in the instant case, we note that the trial court properly rejected the State's contention that Fisher had the apparent authority to consent. This conclusion is consistent with prior Illinois cases rejecting the argument that warrantless entries and searches may be upheld if the party who consented to the entry had apparent authority to do so but lacked actual authority. (*People v. Vought* (1988), 174 Ill. App. 3d 563, 528 N.E.2d 1095); *People v. Bochniak* (1981), 93 Ill. App. 3d 575, 417 N.E.2d 722.

We also agreed with the trial court's finding that Fisher lacked sufficient authority to justify the police action because under the common authority doctrine set out in *Matlock* her consent was not valid. In reaching its determination the trial court mentioned the following factors established by the evidence as controlling: (1) Ms. Fisher's name was not on the lease and she did not contribute to the rent; (2) defendant's apartment was not her exclusive or even her usual place of residence, rather, she was an infrequent visitor, guest or invitee; (3) she did not have access to the apartment when defendant was not there and, like a guest, she only had access when defendant was present; (4) she never brought people over to the apartment; and (5) she moved her clothes; and more importantly, her children to her mother's residence. All of these factors indicate that Fisher did not have the common authority over the defendant's apartment that was necessary to make her consent to enter valid.

The fact that the evidence seized was in plain view does not change the outcome of this case because the plain view doctrine is dependent upon an original lawful entry (*People v. Patrick* (1981), 93 Ill. App. 3d 830, 417 N.E.2d 1056), and we have held the evidence does not contravene the conclusion that the original entry was unlawful. Therefore, the trial court's decision to grant defendant's motion to suppress was proper.

For the reasons set forth above, the judgment of the circuit court is affirmed.

Judgement [sic] affirmed.

FREEMAN, P.J., with McNAMARA and WHITE, JJ., concurring.

ILLINOIS SUPREME COURT  
JULEANN HORNYAK, CLERK  
SUPREME COURT BUILDING  
SPRINGFIELD, ILL. 62706  
(217) 782-2035  
April 5, 1989

Hon. Richard M. Daley  
State's Attorney, Criminal Appeals Div.  
309 Richard J. Daley Center  
Chicago, IL 60602

No. 68295 - People State of Illinois, petitioner, v. Edward Rodriguez,  
respondent. Leave to appeal, Appellate Court, First District.

The Supreme Court today DENIED the petition for leave to appeal  
in the above entitled cause.

The mandate of this Court will issue to the Appellate Court on April  
27, 1989.

# ***Moore v. Regents of the University of California: More for Biotechnology, Less for Patients***

## **I. INTRODUCTION**

Human biological materials<sup>1</sup> are frequently used in biotechnological research. These materials are useful in the development or production of novel hybridomas, cell lines, therapeutically active proteins, and antibodies for diagnostic or therapeutic purposes. Several interesting legal questions arise when these materials are obtained during a necessary therapeutic procedure. These issues include the respective rights of the parties to the products of the research and the consent that must be obtained for the use of the biological materials.

In *Moore v. Regents of the University of California*,<sup>2</sup> a patient, whose excised spleen was used to develop a cell line, asserted a right to share in the profits that were the result of research on his biological materials. The California Supreme Court decided that a physician must disclose his research interests and that the patient has no ownership interest in his biological materials which are used in the research.<sup>3</sup>

This Note discusses whether the common-law obligation of disclosure by the physician to the patient is applicable when human biological material is obtained during a necessary therapeutic procedure. Second, this Note considers whether the common-law doctrine of informed consent protects the patient's right to consent to the disposition of or use of the biological materials removed from his body. This Note explores whether the recognition of conversion as a cause of action expands the common-law doctrine. Finally, the most important issue, which arises out of the *Moore* case, is whether existing legal doctrines can effectively resolve the issues posed by the rapidly developing field of biotechnology, or alternatively, whether the advance of science, in particular biotechnology, has outpaced the development of the law.<sup>4</sup>

### **A. Biotechnology**

Biotechnology is currently one of the most rapidly developing areas of science. The rapid growth and development are primarily attributable

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1. The term "human biological materials" will be used to describe all materials obtained from humans that can be used in research including, but not limited to, blood, serum, saliva, urine, organs, and tissues.

2. 51 Cal. 3d 120, 793 P.2d 479, 271 Cal. Rptr. 146 (1990).

3. *Id.* at 146, 793 P.2d at 497, 271 Cal. Rptr. at 164.

4. See Wagner, *The Legal Impact of Patient Materials used for Product Development in the Biomedical Industry*, 33 CLINICAL RESEARCH 444 (1985) (Wagner suggested that the rapid development of biomedical science has outstripped the law's ability to keep up).

to two important discoveries. In 1953, Watson and Crick discovered the structure of DNA,<sup>5</sup> which is the discrete unit responsible for the characterization of all living organisms.<sup>6</sup> In 1973, Cohen and Boyer disclosed a method for transferring genetic information from one organism to another.<sup>7</sup> Scientists have expanded the frontiers of science beyond these initial discoveries to create a field of science that was virtually nonexistent less than forty years ago.

Biotechnology comprises three main areas of technology: tissue and cell culture technology, hybridoma technology, and recombinant DNA technology.<sup>8</sup> Tissue and cell culture technology generally include research directed toward the development of a cell line which can grow and reproduce in a continuous culture. Establishing a human cell line<sup>9</sup> is particularly difficult; however, the probability of success is substantially increased when tumor cells are used.<sup>10</sup>

A second area of biotechnology, which is commercially important in the production of antibodies,<sup>11</sup> is hybridoma technology. A hybridoma is a cell that results from the fusion of an antibody-producing cell with a tumor cell.<sup>12</sup> The hybridoma retains the beneficial characteristics of

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5. Prior to 1953, deoxyribonucleic acid (DNA) was believed to be the carrier of a part of the genetic specificity of the chromosomes. However, until the publication by Watson and Crick, the mechanism of exact self-duplication of the genetic material was unknown. The discovery by these scientists of the structure of DNA led to a proposed mechanism of self-replication. The proposed structure was a double helix comprising two complimentary chains. The mechanism of self-replication was postulated to proceed by separation of the two chains and enzymatic synthesis of new complimentary chains. Watson & Crick, *Genetical Implications of the Structure of Deoxyribonucleic Acid*, 171 NATURE 964 (1953).

6. U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, NEW DEVELOPMENTS IN BIOTECHNOLOGY: OWNERSHIP OF HUMAN TISSUES AND CELLS 41 (1987) [hereinafter OTA REPORT].

7. Cohen and Boyer discovered a process for conferring antibiotic resistance in *Escherichia coli* cells. Their method used restriction endonucleases, enzymes which are capable of cleaving double-stranded DNA to produce cohesive ends, to form plasmid DNA segments. The plasmids were then inserted into an *E. coli* by transformation. The procedure was suggested to be useful for the insertion of segments of prokaryotic or eukaryotic chromosomes into independent replicating bacterial plasmids. Cohen, Chang, Boyer, & Helling, *Construction of Biologically Functional Bacterial Plasmids In Vitro*, 70 PROC. NAT'L ACAD. SCI. 3240 (1973).

8. OTA REPORT, *supra* note 6, at 5.

9. A human cell line is defined as cells derived from humans which are capable of continuous and indefinite growth in culture. *Id.* at 33.

10. *Id.* at 5.

11. An antibody is a protein which binds to a specific foreign substance. *Id.* at 37.

12. Kohler and Milstein were the first to report the fusion of a B-lymphocyte with a myeloma cell. The fusion product, a hybridoma, produced homogeneous compositions of antibodies. Kohler & Milstein, *Continuous Cultures of Fused Cells Secreting Antibody of Predefined Specificity*, 256 NATURE 495 (1975).

each of the fusion partners, such as immortality and the ability to produce antibodies. Hybridoma technology has been essential in the development of monoclonal antibodies which are used as diagnostic and therapeutic agents.<sup>13</sup>

Recombinant DNA technology involves the manipulation of the DNA within a cell.<sup>14</sup> For example, a gene which codes for a particular protein is inserted into the genetic material within a cell. The recombinant cell, which contains the foreign DNA, frequently is capable of expressing this genetic information to produce the foreign protein. This technology has been commercially utilized to produce recombinant organisms which are able to metabolically synthesize therapeutically important human proteins.<sup>15</sup>

The rapid increase in the development of biotechnology has resulted in an increase in the use of human biological materials in research. Human biological materials are indispensable as a source of important genetic information, such as a source of DNA that codes for a particular protein or antibody.<sup>16</sup> Also, these materials, in particular human tissues and cells, are useful in the development of human cell lines or in the production of hybridomas.

Researchers obtain human biological materials by a variety of methods.<sup>17</sup> One method of obtaining these materials is from volunteers, who frequently are compensated. A second common method is to request a sample from an organized repository.<sup>18</sup> Also, these materials are frequently obtained directly from the patient, possibly without his knowledge or consent, following a surgical procedure or diagnostic test.<sup>19</sup>

### B. Biotechnology and Law

The use of human biological materials in biotechnological research has raised several important legal questions.<sup>20</sup> These issues may be divided

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13. See D. KATZ, MONOCLONAL ANTIBODIES AND T CELL PRODUCTS (1982).

14. OTA REPORT, *supra* note 6, at 5.

15. See A. BOLTON, RECOMBINANT DNA PRODUCTS: INSULIN, INTERFERON AND GROWTH HORMONE (1984).

16. Human proteins and antibodies are favored for therapy because they are allogenic (derived from a member of the same species) and therefore, less likely to initiate an immunogenic response in the patient.

17. OTA REPORT, *supra* note 6, at 52.

18. Organized repositories include American Type Culture Collection (ATCC); Human Genetic Mutant Cell Repository, Coriell Institute; National Cancer Institute, Biological Carcinogens Branch; and Cell Culture Center, Massachusetts Institute of Technology. *Id.*

19. *The Use of Human Biological Material in the Development of Biomedical Products: Hearings Before the Subcomm. on Investigations and Oversight of the House Comm. on Science and Technology*, 99th Cong., 1st Sess. 83 (1985) [hereinafter Subcomm. Report] (statement of David A. Blake, Ph.D.).

20. The Office of Technology Assessment identified the following issues:

into the following categories: (1) the rights of the physician in the products of his research that are derived from the use of another's biological material; (2) the rights of the patient in the products, profits, or knowledge that is a direct result of research on his biological material; and (3) information that must be disclosed to the patient by the physician regarding the use of the patient's biological materials and potential benefits arising from the research. The resolution of these issues will affect biotechnology research, the biotechnology industry, and the physician-patient relationship.

A recent development in patent law resolved one of these important issues. In 1980, the Supreme Court in *Diamond v. Chakrabarty*<sup>21</sup> determined that a living, human-made microorganism is patentable subject matter under 35 U.S.C. § 101.<sup>22</sup> Chakrabarty filed a patent application which claimed, in part, a genetically engineered bacterium. The patent examiner rejected the applicant's claims on the ground that microorganisms are "products of nature,"<sup>23</sup> and living things are not patentable

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Are bodily substances "property to be disposed of by any means one chooses, including donation or sale?

Do property rights to their genetic identity adhere to individuals or to the species?

Who should make the basic decisions affecting the acquisition of tissues and cells, and under what circumstances should acquisition be permitted or denied?

What are patients and research subjects entitled to know about the potential commercial exploitation of an invention that uses their biological materials? And what is the probability that an individual's tissue and cells will end up in a commercial product?

How is it that inventions incorporating human cells are patentable in the first place? How similar is the invention to the original biological material?

What is the nature of the researcher's contribution versus the source's contribution to the invention?

Who should profit from federally funded research using human tissue? To what extent are the issues raised by ownership of human biological materials related to commercial relationships between universities and companies?

What are the implications of these issues for scientists, physicians, patients, volunteer research subjects, universities, and the biomedical product industry?

OTA REPORT, *supra* note 6, at 1.

21. 447 U.S. 303 (1980).

22. *Id.* at 309. Section 101 provides: "[w]hoever invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof, may obtain a patent therefor, subject to the conditions and requirements of this title." 35 U.S.C. § 101 (1988).

23. The term "product of nature" generally refers to a substance which is naturally produced or naturally occurring and which is not made by man. The Patent Act of 1952 authorizes the grant of a patent when three statutory requirements are met: novelty, utility, and nonobviousness. The "utility" requirement is set forth in 35 U.S.C. § 101 (1988),

under section 101. The Supreme Court held that the genetically engineered organism was patentable subject matter under the statute.<sup>24</sup> To support its conclusion, the Court noted that the Committee Reports for the 1952 Patent Act expressed an intent to "include anything under the sun that is made by man" within the meaning of patentable subject matter under section 101.<sup>25</sup>

Since the Court's decision in *Chakrabarty*, researchers routinely patent hybridomas, proteins, genes, and human cell lines produced through biotechnological research.<sup>26</sup> Upon the issuance of a patent, the researcher (patentee) may prevent others from making, using, or selling the patented invention.<sup>27</sup> When the patent claims subject matter of commercial value, the patentee can license to others the right to practice the invention or the right to sell the claimed subject matter. Therefore, the grant of a patent provides the researchers with certain rights and, in part, answers the question regarding the rights of the researcher in the products of his research. However, the grant or denial of a patent does not address the question regarding the rights of the patient in the products of the research.

The issue regarding the patient's rights in the products of research which directly result from the use of his biological materials has been raised in two recent disputes. The facts are clearly distinguishable on the following grounds: differences in the awareness of the patient in the research, the consent given prior to the use of the patient's biological materials, and the relationship between the patient and the researchers.

The first dispute involved the use of human lymph node cells to produce a hybridoma cell line. In 1981, Drs. Royston and Glassy were investigating the production of monoclonal antibodies with specificity

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and the "novelty" requirement is contained in 35 U.S.C. §§ 101-02 (1988). The final requirement, "nonobviousness," is set forth in 35 U.S.C. § 103 (1988). In *Merck & Co., Inc. v. Olin Mathieson Chemical Corp.*, 253 F.2d 156, 161 (4th Cir. 1958), the United States Court of Appeals noted that "products of nature" may be patented when the three statutory conditions for patentability are satisfied. See Slutsker, *Patenting Mother Nature*, FORBES, Jan. 7, 1991, at 290 (several biotechnology companies have patented *purified* human proteins).

24. *Chakrabarty*, 447 U.S. at 318.

25. *Id.* at 309.

26. Because of the newness, complexity, and rapid development of biotechnology, the pendency period for biotechnology patent applications is longer than for others. In 1989, the pendency period ranged from two and one half to four years. This delay in issuance of patents may have an adverse effect on the United States biotechnology industry. Yoo, *Biotech Patents Become Snarled in Bureaucracy*, Wall St. J., July 6, 1989, at B1, col. 6.

27. Section 271 provides: "whoever without authority, makes, uses or sells any patented invention, within the United States during the term of the patent therefor, infringes the patent." 35 U.S.C. § 271(a) (1988).

for human cancer cells.<sup>28</sup> In particular, their research involved the fusion of lymphatic cells which were obtained from cancer patients<sup>29</sup> to an immortal cell line.<sup>30</sup> Dr. Hagiwara, a biology post-doctoral student from Japan, suggested that Drs. Royston and Glassy use lymph node cells from his mother, who was diagnosed as having cervical cancer.<sup>31</sup> Dr. Glassy successfully developed a novel hybridoma cell line which produces antibodies to cervical cancer.<sup>32</sup> The Hagiwaras asserted the rights to the cell line and the antibodies on the ground that the genes were responsible for the production of the antibodies and were derived from Hagiwara's cells.<sup>33</sup>

It is important to note that, prior to the commencement of the research, the parties did not enter into an agreement with respect to the rights of the parties.<sup>34</sup> Unfortunately, the rights of the parties in the products of the research were not addressed by a court. The parties voluntarily settled their dispute, agreeing that the university would retain all patent rights and that the Hagiwaras would receive an exclusive license to practice the invention in Asia.<sup>35</sup>

The second case involved the use of a patient's diseased spleen to develop a commercially valuable cell line. In September 1976, John Moore was diagnosed as having hairy-cell leukemia. Because he requested a second opinion, Moore was referred to David W. Golde, M.D., head of the Oncology-Hematology Department at the University of California at Los Angeles (U.C.L.A.) Medical Center. In early October, Dr. Golde confirmed the diagnosis and recommended a splenectomy. On the day before the surgery, Moore signed a general consent form which specifically authorized the splenectomy and provided for the disposal of any severed tissue by cremation.<sup>36</sup>

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28. Royston, *Cell Lines from Human Patients: Who Owns Them? A Case Report*, 33 CLINICAL RES. 442 (1985).

29. Specimens were obtained from the pathology department at the university. *Id.*

30. OTA REPORT, *supra* note 6, at 38. The particular cell line was a patented human lymphoblastoid B-cell line. This cell line is particularly efficient as a fusion partner with human lymphatic tissue. The parent cell line was derived from the culture of a spleen from a boy with hereditary spherocytosis. U.S. Patent No. 4,451,570, at col. 1, 2 (May 29, 1984).

31. Royston, *supra* note 28, at 442.

32. The novel hybridoma has been designated CLNH5 and is the claimed subject matter of a U.S. Patent. This hybridoma produces monoclonal antibodies which are reactive with cervical cancer cells. These antibodies are potentially suitable for use in the therapy of or diagnosis of cervical cancer. U.S. Patent No. 4,618,577, at col. 2 (Oct. 21, 1986).

33. Royston, *supra* note 28, at 442.

34. *Id.*

35. OTA REPORT, *supra* note 6, at 26.

36. The surgery consent form contained a provision for informing the patient of

Dr. Golde and Shirley Quan, a researcher at the U.C.L.A. Medical Center, obtained a sample of Moore's spleen from the pathologist. Using cell culture technology, Dr. Golde and Quan used Moore's spleen and established a cell line, the Mo cell line, which is capable of growing in a continuous culture for an indefinite period.<sup>37</sup> The Mo cell line produces a number of proteins of commercial interest.<sup>38</sup> Dr. Golde and Quan filed a patent application in 1981 and received a patent in 1984 claiming the Mo cell line, methods for producing proteins by culturing the Mo cell line, and methods for cloning DNA which comprises isolating mRNA<sup>39</sup> from Mo cells.<sup>40</sup>

The Regents of the University of California, as assignee of the patent, Dr. Golde, and Shirley Quan entered into agreements with Genetics Institute, Inc. and Sandoz Pharmaceuticals Corporation (Sandoz) for the commercial development of the Mo cell line and the proteins produced by the Mo cells.<sup>41</sup> These agreements allow Genetics Institute and Sandoz to use the Mo cells to develop commercial products in exchange for payments to Dr. Golde, Quan, and the Regents of the University.<sup>42</sup>

Mr. Moore returned to the U.C.L.A. Medical Center several times between November 1976 and September 1983. Upon each visit, additional samples of his biological materials were removed.<sup>43</sup> During one of his visits in April 1983, Mr. Moore was presented with a consent form which specifically authorized the use of his blood and bone marrow in research. This consent form contained a clause which granted to the

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the disposition of his severed tissue by means other than cremation. However, this space was left blank on Moore's consent form.

37. U.S. Patent No. 4,438,032, at col. 2-3 (March 20, 1984).

38. The Mo cells produce a number of naturally occurring proteins, including erythroid-potentiating activity, colony stimulating factor, human immune interferon, and neutrophil migration-inhibition factor. These proteins regulate the immune system and have a high commercial value as therapeutic agents. The Mo cells are also extremely valuable as a source of the genetic material for these proteins.

39. Messenger ribonucleic acid (mRNA) is the informational intermediate in protein synthesis. The genetic information is contained in DNA; however, a complex multi-step process is required for the transformation of the DNA's genetic information into the synthesis of proteins. Through a process known as transcription, an mRNA molecule is synthesized that is complementary to its DNA template. The mRNA is used in translation as a template for the synthesis of a specific protein. L. STRAYER, BIOCHEMISTRY 597-618 (2d ed. 1981).

40. U.S. Patent No. 4,438,032, at col. 24-26 (March 20, 1984).

41. Moore v. Regents of Univ. of Cal., 51 Cal. 3d 120, 127, 793 P.2d 479, 482, 271 Cal. Rptr. 146, 149 (1990).

42. Genetics Institute has paid at least \$330,000 and Sandoz added an additional \$110,000.

43. These samples included blood, blood serum, bone marrow aspirate, and sperm.

University "any and all rights [Moore], or [Moore's] heirs, may have in any cell line or any other potential product."<sup>44</sup> Mr. Moore voluntarily signed this consent form after he was told that the form was a standard form and was necessary for continued medical treatment.

In September 1983, Moore returned to the Medical Center and was presented with an identical consent form. Mr. Moore inquired whether there was a commercial or financial interest involved in the research on his blood. He was not informed of the commercial value of his biological materials, but was told that the consent form was merely a formality. However, on this visit, Moore did not sign the consent form and therefore, did not grant to the University of California the rights in any cell line or products derived from his biological materials. Because of the unusual circumstances surrounding Moore's failure to sign the consent form, Moore sought legal counsel.

In 1984, Moore filed a lawsuit claiming that he was entitled to share in the profits resulting from the use of his biological materials in research. Moore asserted that Dr. Golde had an intent to do research on Moore's biological material prior to the surgery. Moore also asserted that Dr. Golde never informed him of any plans to conduct research on his spleen or other biological materials. The third amended complaint, which named Dr. Golde, Quan, the Regents of the University of California, Genetics Institute, and Sandoz as defendants, alleged thirteen causes of action, including conversion, lack of informed consent, and breach of a fiduciary duty.<sup>45</sup> The superior court sustained a general demurrer to the entire complaint on the grounds that the allegations regarding conversion were defective and that the remaining causes of action incorporated these defective allegations.

The California Court of Appeal reversed the superior court's decision and held that the complaint did state a cause of action for conversion. The court of appeal concluded that a person has a property right in his own biological materials and, absent his consent or lawful justification, the unauthorized use of his tissue constitutes conversion. Also, the court of appeal directed the superior court to address the remaining causes of action that had not been addressed in the court below. The California Supreme Court held that Moore's third amended complaint

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44. Subcomm. Report, *supra* note 19, at 268.

45. Moore stated the following causes of action: (1) conversion; (2) lack of informed consent; (3) breach of fiduciary duty; (4) fraud and deceit; (5) unjust enrichment; (6) quasi-contract; (7) bad faith breach of the implied covenant of good faith and fair dealing; (8) intentional infliction of emotional distress; (9) negligent misrepresentation; (10) intentional interference with prospective advantageous economic relationships; (11) slander of title; (12) accounting; (13) declaratory relief. *Moore*, 51 Cal. 3d at 128 n.4, 793 P.2d at 482 n.4, 271 Cal. Rptr. at 149 n.4.

did state a cause of action for breach of the physician's fiduciary duty to the patient or lack of informed consent, but the complaint did not state a cause of action for conversion.<sup>46</sup> The bases of the court's decision will be discussed and analyzed in detail below.

## II. PHYSICIAN'S DISCLOSURE OBLIGATION

Before considering the extent to which the physician's disclosure obligation is applicable to protect the patient from commercial exploitation, it is necessary to consider the basis of this disclosure obligation and the common-law doctrines of informed consent and physician's fiduciary duty.

### A. Common Law Disclosure Obligations

The physician's disclosure obligation arises from the right of a patient to personal autonomy. This autonomy includes the ability "to determine what shall be done with [one's] own body."<sup>47</sup> This right protects the patient's interest in the exclusive ability to decide to reject or consent to treatment of his own body.<sup>48</sup> Because of the importance of personal autonomy, both the common law<sup>49</sup> and statutory law<sup>50</sup> impose an obligation of disclosure upon physicians.

The courts consider the relationship between a patient and his physician to be a fiduciary relationship.<sup>51</sup> As a fiduciary, the physician has a duty to fully disclose any facts which materially affect the patient's rights and interests.<sup>52</sup> The purpose of the full disclosure requirement is to provide the patient with an adequate basis to form an intelligent

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46. *Id.* at 147, 793 P.2d at 497, 271 Cal. Rptr. at 164.

47. *Schloendorff v. Society of N.Y. Hosps.*, 211 N.Y. 125, 129-30, 105 N.E. 92, 93 (1914) ("Every human being of adult years and sound mind has a right to determine what all be done with his own body.").

48. *Cobbs v. Grant*, 8 Cal. 3d 229, 243, 502 P.2d 1, 10, 104 Cal. Rptr. 505, 514 (1972).

49. R. FADEN & T. BEAUCHAMP, A HISTORY AND THEORY OF INFORMED CONSENT (1986); F. ROZOVSKY, CONSENT TO TREATMENT — A PRACTICAL GUIDE (1984).

50. CAL. HEALTH & SAFETY CODE § 24171 (West 1984). Title 22 of the California Administrative Code requires hospitals to adopt a written policy on patient's rights. These rights include the right to receive sufficient information in order to give informed consent and the right to participate actively in decisions regarding medical care. CAL. ADMIN. CODE tit. 22, § 70707 (1990). See also 45 C.F.R. §§ 46.101 to -.409 (1990).

51. *Bowman v. McPheeters*, 77 Cal. App. 2d 795, 176 P.2d 745 (1947) (the relationship between the physician and patient is a fiduciary one). See also *Nelson v. Gaunt*, 125 Cal. App. 3d 623, 178 Cal. Rptr. 167 (1981) (duty of disclosure is a fiduciary one); *Berkey v. Anderson*, 1 Cal. App. 3d 790, 82 Cal. Rptr. 67 (1969); *Stafford v. Shultz*, 42 Cal. 2d 767, 270 P.2d 1 (1954).

52. *Bowman*, 77 Cal. App. 2d at 800, 176 P.2d at 748.

decision regarding consent to the proposed treatment.<sup>53</sup> A breach of this duty subjects the physician to liability,<sup>54</sup> especially when there is material concealment or misrepresentation.<sup>55</sup>

Physicians have been held liable under an intentional tort theory when they do not make full disclosure prior to treatment. In *Schloendorff v. Society of New York Hospitals*,<sup>56</sup> a patient who consented only to an examination had a tumor removed while unconscious.<sup>57</sup> The New York Court of Appeals noted that a physician who performs an operation without the patient's consent commits an assault.<sup>58</sup> More recently, in *Barber v. Superior Court*,<sup>59</sup> the California Court of Appeal noted that a physician who performs treatment in the absence of informed consent commits an actionable battery.<sup>60</sup>

Today, courts treat the failure of a physician to make a full disclosure as negligence, frequently referred to as lack of informed consent.<sup>61</sup> Informed consent occurs when the physician discloses to the patient all material risks and alternatives to therapy in such a manner that the patient fully understands and may intelligently consent to treatment.<sup>62</sup> The physician has a duty to inform the patient of all information that is material to his decision.<sup>63</sup> When the physician fails to obtain informed consent, he is liable for negligently failing his duty of reasonable disclosure.

The doctrines of informed consent and duty to disclose are not equivalent, but both are applicable in all cases. The former focuses on the patient's understanding of the risks or alternatives or whether the

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53. See *Berkey*, 1 Cal. App. 3d at 790, 82 Cal. Rptr. at 67.

54. *Id.* at 803, 82 Cal. Rptr. at 77.

55. *Pashley v. Pacific Elec. Ry. Co.*, 25 Cal. 2d 226, 153 P.2d 325 (1944) (when there is a duty to disclose, the disclosure must be full and complete, any material concealment or misrepresentation will amount to a fraud sufficient to entitle the party injured to an action).

56. 211 N.Y. 125, 105 N.E. 92 (1914).

57. *Id.* at 128, 105 N.E. at 93.

58. *Id.* (except in an emergency situation when it is necessary to operate before consent can be obtained).

59. 147 Cal. App. 3d 1006, 195 Cal. Rptr. 484 (1983).

60. *Id.* at 1015, 195 Cal. Rptr. at 489.

61. D. DOBBS, TORTS AND COMPENSATION — PERSONAL ACCOUNTABILITY AND SOCIAL RESPONSIBILITY FOR INJURY 83 (1985).

62. *Canterbury v. Spence*, 464 F.2d 772, 780 n.15 (D.C. Cir. 1972) (effective consent, "informed consent," arises when the patient understands the alternatives to and the risks of the proposed therapy).

63. *Id.* at 786; *Cobbs v. Grant*, 8 Cal. 3d 229, 243, 502 P.2d 1, 11, 104 Cal. Rptr. 505, 515 (1972) (a physician has a duty of reasonable disclosure of the alternatives and of the inherent and potential risks of the proposed therapy, including all material information as determined by the patient's need).

consent was based upon sufficient information, while the latter focuses on the physician's disclosure.<sup>64</sup> For example, a physician may fully discharge his duty to disclose, but the patient may not comprehend or understand what the physician has told him. In this case, the physician has satisfied his disclosure obligation; however, the consent is not considered "informed consent."

The doctrine of informed consent is generally applied in instances in which the physician unreasonably withholds information that is material to the patient's decision to consent to therapy. In one case, the physician may be negligent for failing to disclose the inherent risk of therapy.<sup>65</sup> In another case, the physician may be negligent for failing to disclose the extent of the patient's injuries.<sup>66</sup> Both cases focus on the patient's condition and the available choices and risks of the proposed therapy.

### B. Statutory Disclosure Obligations

Statutes establish the standard of disclosure that is applicable when patients are used in medical experimentation. Federal regulations, which were promulgated by the Department of Health and Human Services (DHHS),<sup>67</sup> specifically enumerate the basic elements that are required for informed consent.<sup>68</sup> However, the application of these regulations is

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64. *Canterbury*, 464 F.2d at 780 n.15 (the duty of disclosure is described as the *sine qua non* of informed consent).

65. See R. KEETON, PROSSER & KEETON ON TORTS § 32, at 190-191 (5th ed. 1984).

66. Courts have held that failing to disclose the extent of a patient's injuries constitutes fraudulent concealment. *Bowman v. McPheeters*, 77 Cal. App. 2d 795, 800, 176 P.2d 745, 747 (1947).

67. 45 C.F.R. §§ 46.101 to -.409 (1990).

68. The basic elements of informed consent are:

- (1) A statement that the study involves research, an explanation of the purposes of the research and the expected duration of the subject's participation, a description of the procedures to be followed, and identification of any procedures which are experimental;
- (2) A description of any reasonably foreseeable risks or discomforts to the subject;
- (3) A description of any benefits to the subject or to others which may reasonably be expected from the research;
- (4) A disclosure of appropriate alternative procedures or courses of treatment, if any, that might be advantageous to the subject;
- (5) A statement describing the extent, if any, to which confidentiality of records identifying the subject will be maintained;
- (6) For research involving more than minimal risk, an explanation as to whether any compensation and an explanation as to whether any medical treatments are available if injury occurs and, if so, what they consist of, or where further information may be obtained;

limited to research involving human subjects conducted by DHHS or funded by DHHS.<sup>69</sup> Also, the regulations exempt research involving the collection or study of pathological specimens or diagnostic specimens.<sup>70</sup> Therefore, the federal regulations are not controlling when human biological materials are obtained during or after a necessary therapeutic procedure.

A number of states have enacted legislation to protect the rights of individuals who participate in medical experimentation.<sup>71</sup> California has attempted to provide minimum statutory protection for individuals under the Protection of Human Subjects in Medical Experimentation Act.<sup>72</sup> The Act sets forth the experimental subject's bill of rights,<sup>73</sup> which are

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- (7) An explanation of whom to contact for answers to pertinent questions about the research and research subject's rights, and whom to contact in the event of a research-related injury to the subject; and
  - (8) A statement that participation is voluntary, refusal to participate will involve no penalty or loss of benefits to which the subject is otherwise entitled, and the subject may discontinue participation at any time without penalty or loss of benefits to which the subject is otherwise entitled.

*Id.* § 46.116.

69. *Id.* § 46.101.

70. *Id.* § 46.101(b)(5).

71. California, New York, and Virginia have enacted such legislation. *OTA REPORT, supra* note 6, at 95.

72. CAL. HEALTH & SAFETY CODE §§ 24170-24179.5 (West 1984).

73. Section 24172 provides:

As used in this chapter, "experimental subject's bill of rights," means a list of the rights of a subject in a medical experiment, in a language in which the subject is fluent. Except as otherwise provided in Section 24175, this list shall include, but not be limited to the subject's right to:

- (a) Be informed of the nature and purpose of the experiment.
- (b) Be given an explanation of the procedures to be followed in the medical experiment, and any drug or device to be utilized.
- (c) Be given a description of any attendant discomforts and risks reasonably to be expected from the experiment.
- (d) Be given an explanation of any benefits to the subject reasonably to be expected from the experiment, if applicable.
- (e) Be given a disclosure of any appropriate alternative procedures, drugs or devices that might be advantageous to the subject, and their relative risks and benefits.
- (f) Be informed of the avenues of medical treatment, if any, available to the subject after the experiment if complications should arise.
- (g) Be given an opportunity to ask any questions concerning the experiment or the procedures involved.
- (h) Be instructed that consent to participate in the medical experiment may be withdrawn at any time and the subject may discontinue participation in the medical experiment without prejudice.
- (i) Be given a copy of the signed and dated written consent form as provided

similar to the DHHS regulations.<sup>74</sup> However, the Act's definition of "medical experiment" does not include research using severed human tissue.<sup>75</sup> As in the case of the federal regulations, the state regulations generally apply to research on the human body as a whole and are not applicable when the biological materials are obtained during a necessary procedure and subsequently used in research.

### C. *Moore v. Regents: Disclosure Obligation*

The California Supreme Court, in *Moore v. Regents of the University of California*,<sup>76</sup> articulated a new standard for a physician's disclosure obligation. The *Moore* court held that a physician must disclose his personal interests, which potentially affect his medical judgement, to satisfy his fiduciary duty of disclosure and to obtain informed consent.<sup>77</sup> These personal interests include the physician's research or economic interests.<sup>78</sup> It is important at this point to note that only the physician's research or economic interests, which are "unrelated to the patient's health" and "that may affect [the physician's] medical judgment," must be disclosed.<sup>79</sup> This new standard requires a determination of the research or economic interests that affect a physician's medical judgment.

The *Moore* court's decision was based on three general principles. The first principle is the right of the patient to personal autonomy.<sup>80</sup>

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by Section 24173 or 24178.

- (j) Be given an opportunity to decide to consent or not to consent to a medical experiment without the intervention of any element of force, fraud, deceit, duress, coercion, or undue influence on the subject's decision.

*Id.* § 24172.

74. 45 C.F.R. §§ 46.101 to -.409 (1990).

75. Section 24174 provides:

As used in this chapter, "medical experiment" means:

(a) The severance or penetration of tissues of a human subject or the use of a drug or device, as defined in Section 26009 or 26010, electromagnetic radiation, heat or cold, or a biological substance or organism, in or upon a human subject in the practice or research of medicine in a manner not reasonably related to maintaining or improving the health of such subject or otherwise directly benefiting such subject.

(b) The investigational use of a drug or device as provided in Sections 26678 or 26679.

(c) Withholding medical treatment from a human subject for any purpose other than the maintenance or improvement of the health of such subject.

CAL. HEALTH & SAFETY CODE § 24174 (West 1984).

76. 51 Cal. 3d 120, 793 P.2d 479, 271 Cal. Rptr. 146 (1990).

77. *Id.* at 132, 793 P.2d at 485, 271 Cal. Rptr. at 152.

78. *Id.*

79. *Id.*

80. *Id.*

The second principle is the requirement that, to be effective, the patient's consent to treatment must be informed consent.<sup>81</sup> Thirdly, the physician has an obligation to disclose all information which is material to the patient's decision.<sup>82</sup> Based upon these three principles, the court concluded that a physician must disclose personal interests that may affect his professional judgment.<sup>83</sup>

Prior to the *Moore* decision, the scope of the physician's disclosure obligation was measured by the information material to the patient's decision.<sup>84</sup> Information is considered material if "a reasonable person, in what the physician knows or should know to be the patient's position, would likely attach significance to the risk or cluster of risks in deciding whether or not to forego the proposed therapy."<sup>85</sup> This standard considers only the inherent dangers and alternatives to proposed therapy.<sup>86</sup> This standard does not require disclosure of the physician's personal interests.

The *Moore* Court, in noting that informed consent requires disclosure of a physician's personal interests,<sup>87</sup> cited *Magan Medical Center v. California State Board of Medical Examiners*.<sup>88</sup> The California Court of Appeal in *Magan* held that a statute which prohibited medical partnerships from owning pharmacies was constitutional.<sup>89</sup> The *Magan* court, however, noted that a physician "who has a financial interest in where his prescriptions are filled" may be influenced by a profit motive in prescribing a drug for his patient.<sup>90</sup> The *Magan* court stated, "Certainly a sick patient deserves to be free of any reasonable suspicion that his doctor's judgment is influenced by a profit motive."<sup>91</sup>

An earlier case in California required disclosure of more than the physician's economic interests. In *Bowman v. McPheeters*,<sup>92</sup> the California Court of Appeal noted that the physician's fiduciary duty requires disclosure of all facts which materially affect the patient's rights and

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81. *Id.*

82. *Id.*

83. *Id.*

84. *Cobbs v. Grant*, 8 Cal. 3d 229, 245, 502 P.2d 1, 11, 103 Cal. Rptr. 505, 515 (1972).

85. *Canterbury v. Spence*, 464 F.2d 772, 787 (D.C. Cir. 1972).

86. See *Morgenroth v. Pacific Medical Center, Inc.*, 54 Cal. App. 3d 521, 126 Cal. Rptr. 681 (1976) (physician's disclosure that the proposed procedure carried risk of death or serious disease met the materiality requirement).

87. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 129, 793 P.2d 479, 483, 271 Cal. Rptr. 146, 150 (1990).

88. 249 Cal. App. 2d 124, 57 Cal. Rptr. 256 (1967).

89. *Id.* at 128, 57 Cal. Rptr. at 259.

90. *Id.* at 132, 57 Cal. Rptr. at 262.

91. *Id.*

92. 77 Cal. App. 2d 795, 176 P.2d 745 (1947).

interests.<sup>93</sup> This standard, as applied to the duty to disclose, appears to be broader than the disclosure requirement under the doctrine of informed consent. The *Bowman* standard requires disclosure of information that affects the patient's rights and interests, and not disclosure only of the physician's interests. However, the *Moore* Court failed to cite *Bowman* in support of its conclusion.

The *Moore* court noted that a physician who has a research interest in his patient has potentially conflicting loyalties.<sup>94</sup> The court suggested that a physician may perform tests which are of no benefit to his patient.<sup>95</sup> However, the performance of an unnecessary test will require consent by the patient.<sup>96</sup> The court suggested that the decision to undergo tests is made exclusively by the physician.<sup>97</sup> However, under California law, the decision to consent to tests or therapy is vested exclusively in the patient.<sup>98</sup>

The *Moore* Court held that Moore's third amended complaint stated a cause of action for breach of the physician's disclosure obligation;<sup>99</sup> however, the court did not decide whether Moore could prevail on this issue. Two important elements of breach of the physician's disclosure obligation are materiality<sup>100</sup> and causation.<sup>101</sup> In order for Moore to succeed on remand, he must prove these two problematic elements.

The question is whether a physician's personal interests in using his patient's biological materials is "material," especially when the proposed procedure is necessary. Information is material if a reasonable person would be likely to attach significance to the information in deciding whether to undergo the proposed therapy.<sup>102</sup> The use of a patient's tissue after it is removed, especially if the tissue is diseased and is the cause of the patient's illness, is not likely to be considered significant in making a decision to consent to treatment.<sup>103</sup> As the courts generally recognize,

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93. *Id.* at 800, 176 P.2d at 748.

94. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 130, 793 P.2d 479, 484, 271 Cal. Rptr. 146, 151 (1990).

95. *Id.*

96. *Id.*

97. *Id.*

98. *Cobbs v. Grant*, 8 Cal. 3d 229, 244, 502 P.2d 1, 10, 104 Cal. Rptr. 505, 514 (1972).

99. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 125, 793 P.2d 479, 480, 271 Cal. Rptr. 146, 147 (1990).

100. *Canterbury v. Spence*, 464 F.2d 772, 786 (D.C. Cir. 1972).

101. *Cobbs*, 8 Cal. 3d at 245, 502 P.2d at 11, 104 Cal. Rptr. at 515.

102. See *supra* note 85.

103. Certain religious groups have beliefs or traditions which do not allow the use of human biological materials in research or transplantation. See CAL. HEALTH & SAFETY CODE § 7152 (West Supp. 1991); Subcomm. Report, *supra* note 19, at 122 (statement of Thomas Murray).

the patient is usually more concerned with the risks or alternatives to the proposed therapy. Therefore, a physician's personal interests in the use of his patient's biological materials is not likely to be considered material, especially when the proposed therapy is necessary or highly recommended.

The problem of proving a causal relationship was noted by the California Supreme Court in *Cobbs*.<sup>104</sup> The standard for showing a causal relationship requires the patient to show that if the material information had been disclosed, the patient would not have consented to the therapy.<sup>105</sup> If the physician would have disclosed the information and the patient would have consented, then no causal relationship exists, and the physician is not liable for his failure to disclose the information.

In *Moore*, Golde informed Moore that a splenectomy was necessary to treat his disease. Based upon Golde's recommendation, Moore consented to treatment without knowledge of Golde's research interests. For Moore to show that Golde breached his duty of disclosure under the doctrine of informed consent, Moore must show that he would not have consented, or more properly, a reasonable person would not have consented,<sup>106</sup> to the proposed splenectomy. Because the splenectomy was necessary to treat Moore's illness, the disclosure of Golde's research interests prior to surgery arguably would not have affected Moore's decision to consent to the procedure.

In his dissenting opinion in *Moore*, Justice Mosk suggested that the cause of action for breach of the disclosure obligation is not sufficient to protect patients from commercial exploitation.<sup>107</sup> First, Justice Mosk noted that under a reasonably prudent person standard causation will be difficult to show.<sup>108</sup> Secondly, the nondisclosure cause of action does not give the patient affirmative rights; the action only allows the patient to withhold consent.<sup>109</sup> Justice Mosk further noted that the cause of action does not give the patient the right to share in the profits from commercialization,<sup>110</sup> which is the primary purpose of Moore's suit. Also,

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104. *Cobbs v. Grant*, 8 Cal. 3d 299, 245, 502 P.2d 1, 11, 104 Cal. Rptr. 505, 515 (1972) (between the physician's failure to inform and the injury to the plaintiff there must be a causal relationship which arises only if the patient shows that he would not have consented if he was given the information).

105. *Id. See also Canterbury v. Spence*, 464 F.2d 772, 790 (D.C. Cir. 1972).

106. *Cobbs*, 8 Cal. 3d at 245, 502 P.2d at 11, 104 Cal. Rptr. at 515 (the court adopted an objective test, whether a prudent person in the patient's position would have consented if adequately informed).

107. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 182, 793 P.2d 479, 521, 271 Cal. Rptr. 146, 188 (Mosk, J., dissenting).

108. *Id. at 179*, 793 P.2d at 519, 271 Cal. Rptr. at 186 (Mosk, J., dissenting).

109. *Id. at 180*, 793 P.2d at 520, 271 Cal. Rptr. at 187 (Mosk, J., dissenting).

110. *Id.*

a nondisclosure cause of action potentially affects only those in a physician-patient relationship.<sup>111</sup> The parties who profit from the commercialization of the patient's biological materials may escape liability if they are not in a physician-patient (fiduciary) relationship.

In *Moore*, the court stated that Quan, the Regents, Genetics Institute, and Sandoz were not in a fiduciary relationship with Moore.<sup>112</sup> The *Moore* court concluded that these defendants are liable for Golde's acts only on the basis of secondary liability, for example, respondeat superior.<sup>113</sup> Such a relationship will be extremely difficult to prove, especially with respect to Genetics Institute and Sandoz. These defendants did not direct or participate in Golde's wrongful acts, but became involved long after the splenectomy. Therefore, these parties will most likely avoid liability.

The new standard of disclosure, as articulated by the *Moore* court, will not be an effective means for protecting the patient from commercial exploitation. The California Supreme Court requires disclosure of the physician's personal interests that are unrelated to the patient's health and that may affect the physician's medical judgment.<sup>114</sup> However, this high disclosure standard may be rendered ineffective by the remaining elements of the cause of action, materiality and causation. If the failure of the physician to disclose his personal research interests is not a cause of the patient's injury, then the physician may not be held liable.

The *Moore* court noted that a physician's research interests "may affect his judgment."<sup>115</sup> However, a physician's research interest, in reality, is secondary to his interest in treating the patient. Also, research on human biological material is unpredictable. The probability of discovering a commercially valuable product is extremely low.<sup>116</sup> The court's assertion that the physician's judgment may be affected by a desire to advance his research objectives without considering the potential benefits to the patient is unlikely.

A more appropriate standard would require disclosure of all information that is related to the *patient's interests*. This standard was articulated by the California Court of Appeal in *Bowman v. McPheeters*.<sup>117</sup> In *Bowman*, the court stated that as a part of the physician's fiduciary duty, the physician has a duty to disclose all facts which

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111. *Id.* at 181, 793 P.2d at 521, 271 Cal. Rptr. at 188 (Mosk, J., dissenting).

112. *Id.* at 133, 793 P.2d at 486, 271 Cal. Rptr. at 153.

113. *Id.*

114. *Id.* at 131-32, 793 P.2d at 485, 271 Cal. Rptr. at 152.

115. *Id.* at 130, 793 P.2d at 484, 271 Cal. Rptr. at 151.

116. OTA REPORT, *supra* note 6, at 55.

117. 77 Cal. App. 2d 795, 176 P.2d 745 (1947).

materially affect the patient's rights and interests.<sup>118</sup> A patient certainly has an interest in knowing whether his physician plans to use his biological materials in research. A patient may obtain great personal satisfaction in knowing that his biological materials are being used in medical research. The *Bowman* standard properly views the requirement of disclosure from the patient's perspective and not from the physician's perspective.<sup>119</sup> Recognition of this standard does not create new rights for the patient; it only requires disclosure of all information that affects the patient's rights and interests.

### III. CONVERSION

#### A. Common-Law Doctrine

Conversion is based on the common-law action of trover.<sup>120</sup> Trover was originally defined as an action on the case for the recovery of damages against a finder of another's goods who wrongfully converted the goods to his own use.<sup>121</sup> This tort became an action for "any wrongful interference with or the detention of the goods of another."<sup>122</sup> The plaintiff, if successful in his pleading, was generally awarded damages in the value of the chattel at the time of dispossessio<sup>n</sup>.<sup>123</sup>

The modern doctrine of conversion protects the owner or person entitled to possession of property from another exercising unjustified and unwarranted control over it.<sup>124</sup> Conversion has been defined as "any act of dominion wrongfully exerted over another's personal property in denial of or inconsistent with his rights therein."<sup>125</sup> An action for conversion of personal property requires the plaintiff to show the following elements: "(1) plaintiff's ownership or right to possession of the property at the time of conversion; (2) defendant's conversion by a wrongful act

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118. *Id.* at 800, 176 P.2d at 748.

119. In *Cobbs*, the court rejected as a standard for disclosure the practice of a reasonable medical practitioner and adopted a reasonable prudent person in the patient's position as the appropriate standard. *Cobbs v. Grant*, 8 Cal. 3d 229, 243, 502 P.2d 1, 10, 104 Cal. Rptr. 505, 514 (1972).

120. RESTATEMENT (SECOND) OF TORTS § 222A comment a (1965).

121. BLACK'S LAW DICTIONARY 1351 (5th ed. 1979).

122. *Id.*

123. *Id.* Trover can be contrasted with replevin, which is an action by the owner or the person entitled to possession of goods to recover the goods from another. *Id.* at 1168.

124. *Poggi v. Scott*, 167 Cal. 372, 139 P. 815 (1914) (the foundation for the action of conversion rests upon the unwarranted interference by a defendant with the dominion over the plaintiff's property from which injury results).

125. *Igauye v. Howard*, 114 Cal. App. 2d 122, 126, 249 P.2d 558, 561 (1952).

or disposition of plaintiff's property rights; and (3) damages."<sup>126</sup>

The first element requires the plaintiff to assert ownership or a right to possession of the property at the time of conversion. This element has three aspects which require consideration: ownership or right to possession, property, and time. The settled rule is that absolute ownership of the property is not a prerequisite to maintaining a cause of action.<sup>127</sup> The plaintiff need only have an immediate right to possession at the time of conversion.<sup>128</sup> When the plaintiff has a special interest or qualified right in the property and possession or right of possession at the time of conversion, the combination is sufficient to maintain an action for conversion.<sup>129</sup> Examples of special interests or qualified rights include liens,<sup>130</sup> an interest as a bailee or bailor,<sup>131</sup> equitable title,<sup>132</sup> an interest arising from services rendered,<sup>133</sup> and secured interests.<sup>134</sup>

The second aspect for consideration is the kinds of property that may be converted. Originally, conversion was applicable only to tangible personal property.<sup>135</sup> The basis of this limitation was that intangible property could not be lost and subsequently found, which was the original

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126. Baldwin v. Marina City Properties, Inc., 79 Cal. App. 3d 393, 410, 145 Cal. Rptr. 406, 416 (1978).

127. Everfresh, Inc. v. Goodman, 131 Cal. App. 2d 818, 820, 281 P.2d 560, 561 (1955).

128. Hartford Fin. Corp. v. Burns, 96 Cal. App. 3d 591, 598, 158 Cal. Rptr. 169, 172 (1979).

129. Pope v. National Aero Fin. Co., 236 Cal. App. 2d 722, 46 Cal. Rptr. 233 (1965); *In re Dino*, 17 Bankr. 316 (Bankr. Fla. 1982); Ax v. Schloot, 118 Ind. App. 458, 81 N.E.2d 379 (1948).

130. Bastanchury v. Times-Mirror Co., 68 Cal. App. 2d 217, 156 P.2d 488 (1945) (a lienholder may maintain an action for conversion); *In re Dino*, 17 Bankr. 316 (Bankr. Fla. 1982) (lienholder with possession or a right of possession may bring an action for conversion).

131. Hollywood Motion Picture Equip. Co. v. Furer, 16 Cal. 2d 184, 105 P.2d 299 (1940) (when bailee uses property to detriment of bailor, such use is conversion); Treasure Cay, Ltd. v. Investors Int'l Constr. Corp., 259 So. 2d 169 (Fla. Dist. Ct. App. 1972) (bailee may maintain an action for conversion if he has a present or immediate right of possession).

132. Hart v. Meadows, 302 S.W.2d 448 (Tex. Civ. App. 1957) (equitable title is sufficient to support an action for conversion).

133. Arques v. National Superior, 67 Cal. App. 2d. 763, 155 P.2d 643 (1945) (a person with an interest in property arising from services rendered may maintain an action in trover).

134. Hartford Fin. Corp. v. Burns, 96 Cal. App. 3d 591, 598, 158 Cal. Rptr. 169 (1979) (secured party with right to immediate possession is entitled to maintain a conversion action).

135. R. KEETON, *supra* note 65, § 15, at 91. See Stern v. Kaufman's Bakery, Inc., 191 N.Y.S.2d 734 (N.Y. Sup. Ct. 1959) (court held that a door to door bakery route consists solely of the goodwill of the customers, which is intangible and not a proper subject of conversion).

basis for trover and conversion.<sup>136</sup> Real property was also excluded for the same reasons.<sup>137</sup> The modern doctrine expanded the scope of the term "property" to include intangible personal property.<sup>138</sup>

The third aspect of this first element is the temporal aspect. The plaintiff is required to have an interest in the property, either ownership and the right of possession or actual possession, at the time of the wrongful act of the defendant.<sup>139</sup> The importance of this temporal aspect in *Moore* will be discussed below.

The second element is defendant's conversion by a wrongful act or disposition of the plaintiff's property rights.<sup>140</sup> Conversion does not require that there be an actual taking of the property.<sup>141</sup> If the defendant wrongfully exerts control or ownership of the property or applied the property to his own use, the defendant's act constitutes conversion.<sup>142</sup>

### B. *Moore v. Regents: Conversion*

In *Moore*, the California Supreme Court held that the plaintiff's third amended complaint did not state a cause of action for conversion.<sup>143</sup> The court qualified its holding by stating that it did not hold "that excised cells can never be property for any purpose whatsoever."<sup>144</sup> However, the California Supreme Court concluded that "the use of excised cells in medical research does not amount to a conversion."<sup>145</sup>

In support of its holding and conclusion, the *Moore* Court suggested that finding for the patient, who is the source of the cells, will impose

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136. R. KEETON, *supra* note 65, § 15, at 91.

137. See *California Mut. Ins. Co. v. Robertson*, 213 Cal. App. 3d 1172, 262 Cal. Rptr. 173 (1989).

138. See *A & M Records, Inc. v. Heilman*, 75 Cal. App. 3d 554, 142 Cal. Rptr. 390 (1977) (recorded musical performances are subject to conversion); *Fabricon Prods. v. United Cal. Bank*, 264 Cal. App. 2d 13, 70 Cal. Rptr. 50 (1968) (a check is a subject of conversion); *Shahood v. Cavin*, 154 Cal. App. 2d 745, 316 P.2d 700 (1957) (money can be the subject of conversion when a specific sum capable of identification is involved); *Mears v. Crocker First Nat'l Bank*, 84 Cal. App. 2d 637, 191 P.2d 501 (1948) (shares of corporate stock and stock certificates are subjects of conversion); *In re Estate of Corbin*, 391 So. 2d 731 (Fla. Dist. Ct. App. 1980) (conversion may be brought for the wrongful taking of an intangible interest in a business, including goodwill).

139. *General Motors Acceptance Corp. v. Dallas*, 198 Cal. 365, 370, 245 P. 184, 186 (1926).

140. *Baldwin v. Marina City Properties, Inc.*, 79 Cal. App. 3d 393, 410, 145 Cal. Rptr. 406, 416 (1978).

141. *Igauye v. Howard*, 114 Cal. App. 2d 122, 126, 249 P.2d 558, 561 (1952).

142. *Id.*

143. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 147, 793 P.2d 479, 497, 271 Cal. Rptr. 146, 164 (1990).

144. *Id.* at 142, 793 P.2d at 493, 271 Cal. Rptr. at 160.

145. *Id.*

upon scientists a new tort duty that will have a chilling effect upon medical research.<sup>146</sup> The California Supreme Court noted that Moore's attempt to bring an action under a theory of conversion is "recognized as a request to extend that theory."<sup>147</sup> The *Moore* Court cited three reasons for not imposing liability for conversion: (1) policy considerations; (2) resolution is better left for the legislature; and (3) an alternate cause of action is available.<sup>148</sup>

The *Moore* Court's analysis regarding conversion initially focused on whether Moore's claim of conversion fits within the existing law.<sup>149</sup> Moore asserts that he continued to own his cells following their removal, he never consented to the use of his cells in medical research, and the unauthorized use of his cells constitutes conversion.<sup>150</sup> The *Moore* Court concluded that the application of conversion to the present case "would frankly have to be recognized as an extension of the theory."<sup>151</sup>

As discussed above, an action for conversion requires ownership or a right to possession of the subject converted. The *Moore* Court concluded that Moore did not retain a right to possession of his cells after removal and considered whether he retained an ownership interest in his excised cells.<sup>152</sup> The California Supreme Court decided that Moore did not retain an ownership interest in his cells following removal.<sup>153</sup>

The first reason for concluding that Moore did not retain an ownership interest in his excised cells was the lack of judicial precedent supporting such a claim.<sup>154</sup> Because this is a case of first impression, the parties' and the court's research did not disclose a case on point which held that a person retains an interest in his excised cells.<sup>155</sup> The *Moore* Court dismissed the unwanted publicity cases<sup>156</sup> as not analogous

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146. *Id.* at 134, 793 P.2d at 487, 271 Cal. Rptr. at 154.

147. *Id.* at 142, 793 P.2d at 493, 271 Cal. Rptr. at 160.

148. *Id.*

149. *Id.* at 136, 793 P.2d at 488, 271 Cal. Rptr. at 155.

150. *Id.* at 134, 793 P.2d at 487, 271 Cal. Rptr. at 154.

151. *Id.* at 136, 793 P.2d at 488, 271 Cal. Rptr. at 155.

152. *Id.*

153. *Id.*

154. *Id.*

155. *Id.* The *Moore* court found that this was not surprising because statutory law, both federal and state, dealing with human biological materials does not address property rights of a person in his severed biological material. These statutes are directed to the proper disposal of the materials in accordance with public policy. See CAL. GOV'T CODE §§ 27491.44-27491.47 (West 1988) (provisions governing the conduct of coroners with respect to human biological materials); CAL. HEALTH & SAFETY CODE § 7054.4 (West 1970 & Supp. 1991) (human tissues are disposed of in a method to protect the public health and safety); CAL. HEALTH & SAFETY CODE §§ 7150-7156.5 (West 1970 & Supp. 1991) (provisions governing anatomical gifts).

156. *Motschenbacher v. R. J. Reynolds Tobacco Co.*, 498 F.2d 821 (9th Cir. 1974);

to the present case.<sup>157</sup> Finally, the *Moore* Court concluded that recognition of a property interest in excised biological materials is not necessary to protect human privacy and dignity; fiduciary duty and informed consent more properly protect these interests.<sup>158</sup>

The *Moore* Court's analysis regarding the ownership or right to possession of Moore's human biological materials raises several interesting legal questions. The first question requires a consideration of the temporal aspect of the first element of conversion. To sustain a conversion cause of action it is not necessary that Moore have an ownership interest in his biological materials if he had actual possession at the time of the alleged wrongful act.<sup>159</sup> If conversion occurred at the time of the taking,<sup>160</sup> then Moore had the requisite possession to maintain a conversion action. Moore should have asserted and the court should have recognized that the conversion of his biological materials occurred when these materials were removed, not after Moore lost possession. If conversion is properly viewed as occurring at the time of Moore's splenectomy or at each subsequent visit for the withdrawal of additional biological materials, then a cause of action for conversion clearly exists under common-law principles.

Under the Uniform Anatomical Gift Act,<sup>161</sup> California law recognizes a qualified property right in one's body. This qualified right is the ability to make anatomical gifts, which effectively is the ability to direct the disposition of one's body or parts thereof at death.<sup>162</sup> Under the Act, the donor may also designate a specific donee,<sup>163</sup> which implies a

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Lugosi v. Universal Pictures, 25 Cal. 3d 813, 603 P.2d 425, 160 Cal. Rptr. 323 (1979) (every person has a proprietary interest in his own likeness and unauthorized use is actionable as a tort).

157. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 138, 793 P.2d 479, 490, 271 Cal. Rptr. 146, 157 (1990). The *Moore* court reasoned that Moore's cells were not unique because every human has the ability to manufacture lymphokines. However, the court failed to recognize the fact that Moore's cells were unique because they were infected with HTLV-II. This novel retrovirus was first identified in the Mo cell line. Chen, *Human T-cell Leukemia Virus Type II Transforms Normal Human Lymphocytes*, 80 PROC. NAT'L ACAD. SCI. 7006 (Nov. 1983); Chen, *Molecular Characterization of Genome of a Novel Human T-cell Leukemia Virus*, 305 NATURE 502 (Oct. 6, 1983).

158. *Moore*, 51 Cal. 3d at 140, 793 P.2d at 491, 271 Cal. Rptr. at 158.

159. See *Igauye v. Howard*, 114 Cal. App. 2d 122, 127, 249 P.2d 558, 561 (1952) (plaintiff need not be the owner of the property because actual possession at the time of conversion is sufficient).

160. Justice Broussard suggested that under the traditional common-law principles of conversion, Moore could maintain an action to recover damages. *Moore*, 51 Cal. 3d at 151, 793 P.2d at 499, 271 Cal. Rptr. at 166 (Broussard, J., concurring and dissenting).

161. CAL. HEALTH & SAFETY CODE §§ 7150-7156.5 (West 1970 & Supp. 1991).

162. *Id.* § 7150.5.

163. *Id.* § 7153(b).

right to designate the use of an anatomical gift for research purposes.<sup>164</sup> Because a person has the right to direct the use of his biological material at his death, a person should legally have the same rights with respect to his biological materials prior to death.<sup>165</sup> This qualified property right should be recognized as a sufficient interest in biological materials to entitle the patient to a conversion action for the wrongful or unauthorized use of those materials. Whether the plaintiff had an unlimited or limited right in his biological materials is not an appropriate consideration in deciding a motion for summary judgment. So long as a right existed, summary judgment is not appropriate.

A second question is whether human biological materials, in particular tissues and organs, are tangible or intangible property that is subject to conversion. The *Moore* Court expressly refused to hold that "excised cells can never be property for any purpose whatsoever."<sup>166</sup> However, the question remains whether excised cells can ever be considered property for purposes of conversion.

Two cases, in dicta, suggested that human biological materials are tangible property. In *United States v. Garber*,<sup>167</sup> Ms. Garber was indicted for failing to report as income money that she received in exchange for her plasma.<sup>168</sup> The United States Court of Appeals noted that "blood plasma, like a chicken's eggs, a sheep's wool, or like any salable part of the human body, is tangible property."<sup>169</sup> Based upon this statement, human biological material is arguably the proper subject of conversion.

The second case, *Venner v. State*,<sup>170</sup> was cited by the California Court of Appeal in its decision. The issue in *Venner* was whether balloons, which were filled with narcotics, found in Venner's feces were illegally seized.<sup>171</sup> In dictum, the *Venner* court noted that "[i]t could not be said that a person has no property right in wastes or other materials which were once a part of or contained within his body, but which normally are discarded after their separation from the body."<sup>172</sup> As in *Garber*, the *Venner* court's language suggests that human biological materials

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164. *Id.* § 7153(a)(1).

165. Justice Broussard stated that, under California law, the patient has the right to determine the use of a body part after its removal. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 151, 793 P.2d 479, 499, 271 Cal. Rptr. 146, 166 (1990) (Broussard, J., concurring and dissenting).

166. *Id.* at 142, 793 P.2d at 493, 271 Cal. Rptr. at 160.

167. 607 F.2d 92 (5th Cir. 1979).

168. *Id.* at 93. Her blood contained a rare antibody useful in the production of blood typing serum.

169. *Id.* at 97.

170. 30 Md. App. 599, 354 A.2d 483 (1976).

171. *Id.* at 600, 354 A.2d at 485.

172. *Id.* at 626, 354 A.2d at 498.

may be considered one's tangible property. These two cases support the existence of a property right in one's biological materials. This property right should be sufficient to maintain an action for conversion.

The California Supreme Court placed undue reliance in the availability of an alternate theory for imposing liability. The *Moore* Court suggested that the patient's interests are properly protected under the doctrine of informed consent or by the physician's fiduciary duty.<sup>173</sup> As discussed previously, *Moore* would have to prove both the materiality of the information that was withheld and a causal relationship to impose liability and to be entitled to a recovery.

The *Moore* Court also relied on California statutory law in support of its conclusion. The court cited California Health and Safety Code section 7054.4, noting that a patient has limited control over his excised biological materials.<sup>174</sup> Section 7054.4 requires the safe disposal of human biological materials following the conclusion of their scientific use.<sup>175</sup> The court concluded that this statute drastically limits a patient's control to the extent that the remaining rights in the excised material are not sufficient for purposes of common-law conversion.<sup>176</sup> However, absolute ownership is not necessary to maintain an action for conversion.<sup>177</sup> The California courts previously recognized a qualified interest in property as sufficient for purposes of conversion law.<sup>178</sup>

To further support its rejection of *Moore*'s conversion theory, the *Moore* Court asserted that the subject matter of a U.S. Patent<sup>179</sup> "cannot

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173. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 140, 793 P.2d 479, 491, 271 Cal. Rptr. 146, 158 (1990).

174. *Id.* at 136, 793 P.2d at 488, 271 Cal. Rptr. at 155.

175. Section 7054.4 provides:

Notwithstanding any other provision of law, recognizable anatomical parts, human tissues, anatomical human remains, or infectious waste following conclusion of scientific use shall be disposed of by interment, incineration, or any other method determined by the state department to protect the public health and safety.

As used in this section, "infectious waste" means any material or article which has been, or may have been, exposed to contagious or infectious disease.

CAL. HEALTH & SAFETY CODE § 7054.4 (West Supp. 1991).

176. *Moore*, 51 Cal. 3d at 140, 793 P.2d at 492, 271 Cal. Rptr. at 159.

177. *Everfresh, Inc. v. Goodman*, 131 Cal. App. 2d 818, 820, 281 P.2d 560, 561 (1955) (established rule is ownership, either general or special, or right to immediate possession, is all that is required to maintain an action for conversion, and it is not a requirement that the plaintiff be the absolute owner).

178. See *Ruiz v. Bank of Am. Nat'l Trust & Sav. Ass'n*, 135 Cal. App. 2d 860, 287 P.2d 409 (1955) (a qualified interest in an automobile is sufficient); *Bastanchury v. Times-Mirror Co.*, 68 Cal. App. 2d 217, 156 P.2d 488 (1945) (a lien is a sufficient interest for conversion).

179. U.S. Patent, No. 4,438,032 (March 20, 1984).

be Moore's property."<sup>180</sup> The court noted that the Mo cell line is factually and legally distinct from Moore's cells.<sup>181</sup> Under United States Patent Law,<sup>182</sup> the Mo cell line may be considered distinct from Moore's spleen cells.<sup>183</sup> However, in the present case, Moore's spleen was the subject of the conversion which produced the Mo cell line. The Mo cell line is properly viewed as a modified version of Moore's cells. Although the Mo cell line is distinct, the discovery of this cell line would have been impossible without Moore's biological materials. Therefore, the Mo cell line is properly viewed as the "product" of the conversion and not as the property "converted" or the "subject" of the conversion.

Prior to the splenectomy, Moore signed a consent form which authorized the disposal of his severed tissue by cremation. However, Golde and Quan used the tissue to develop the Mo cell line. In *Hollywood Motion Picture Equipment Co. v. Furer*,<sup>184</sup> the defendant used the plaintiff's property to the detriment of the plaintiff.<sup>185</sup> The court noted that "[i]f a bailee, having no authority to use the thing bailed, uses it, or having authority to use it in a particular way, uses it in a different way, unauthorized by the terms of the bailment . . . such unauthorized use constitutes a conversion."<sup>186</sup> Because Golde and others were authorized to dispose of Moore's biological material by cremation and applied Moore's biological materials to an unauthorized use for their own benefit, a cause of action for conversion exists.

After determining that the recognition of a conversion cause of action required an extension of the common-law theory, the *Moore* court concluded that an extension of the common-law doctrine would not be appropriate.<sup>187</sup> The primary reason for the *Moore* court's refusal to extend liability was the fair balance between competing policies. The first policy consideration was the protection of an individual's right to

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180. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 141, 793 P.2d 479, 492, 271 Cal. Rptr. 146, 159 (1990).

181. *Id.*

182. 35 U.S.C. §§ 1-376 (1988).

183. The Mo cell line was established from Moore's spleen cells by Golde and Quan. The Mo cell line, which is capable of continuous culture for an indefinite period of time, is not naturally occurring, but is a product of human ingenuity. Even though these cells retain some of the characteristics of Moore's spleen cells, such as the ability to produce proteins, the cell line is factually distinguishable from Moore's cells. Because the Mo cell line was "made by man" and Moore's spleen cells are "naturally occurring," only the former are patentable subject matter under 35 U.S.C. § 101. *See Diamond v. Chakrabarty*, 447 U.S. 303 (1980).

184. 16 Cal. 2d 184, 105 P.2d 299 (1940).

185. *Id.* at 189, 105 P.2d at 302.

186. *Id.*

187. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 143, 793 P.2d 479, 493, 271 Cal. Rptr. 146, 160 (1990).

personal autonomy.<sup>188</sup> The second policy consideration was the desire to protect persons engaged in socially useful activities from civil liability.<sup>189</sup> The court sought to protect the patient's interests without imposing an undue burden on socially beneficial biotechnological or medical research.<sup>190</sup> The court concluded that liability based upon the existing disclosure obligations provides sufficient protection of the patient's rights without having a chilling effect on research.<sup>191</sup>

The *Moore* court concluded that the extension of the common-law doctrine to recognize a cause of action for conversion would have an adverse effect on research.<sup>192</sup> The court suggested that the free flow of medically useful human biological materials would be compromised if conversion law was extended.<sup>193</sup> The court asserted that biotechnological and pharmaceutical companies would not be willing to invest in research if such research would subject the company to potential liability.<sup>194</sup>

The exchange of scientific materials is not as free and efficient as the California Supreme Court suggested. Many universities and corporations have entered into collaborative research agreements that usually define the rights of the parties in any discoveries or products of the collaborative efforts.<sup>195</sup> These agreements typically prohibit the transfer of research materials to persons who are not a party to the agreement.<sup>196</sup> The effect of these agreements has been a decrease in the flow of information and scientific samples.<sup>197</sup> Secondly, because of the importance of human biological materials in the development of commercial products,

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188. *Id.*

189. *Id.*

190. In the OTA Report, the uncertainty surrounding the resolution of disputes between physicians and patients, with respect to their respective rights, was suggested to have an impact on both academic research and the biotechnology industry. The Report further suggested that biotechnology companies are unlikely to invest in developing, manufacturing, or marketing a product when uncertainty exists. OTA REPORT, *supra* note 6, at 27.

191. *Moore*, 51 Cal. 3d at 146, 793 P.2d at 495, 271 Cal. Rptr. at 162.

192. *Id.*

193. *Id.*

194. The court characterized the use of biological materials in research as purchasing a ticket in a litigation lottery. *Id.*

195. One example of such an agreement is the standard Cooperative Research and Development Agreement currently in use by the National Institutes of Health and the Alcohol, Drug Abuse and Mental Health Administration (NIH/ADAMHA). See D. MURRAY & P. O'CONNOR, A GUIDE TO CORPORATE SPONSORED UNIVERSITY RESEARCH IN BIOTECHNOLOGY — ISSUES, CONTRACTS, MODELS, AND PERSONNEL (1983).

196. Also, materials may be transferred between the parties with certain restrictions that limit the use of the materials, for example limiting the use to only research purposes. The NIH/ADAMHA material transfer agreement contains such a provision.

197. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 170, 793 P.2d 479, 513, 271 Cal. Rptr. 146, 180 (1990) (Mosk, J., dissenting).

companies are more restrictive in the exchange of samples in order to retain their competitive edge.<sup>198</sup>

The *Moore* court also suggested that the availability of patent protection increases the availability of research materials.<sup>199</sup> The court failed to recognize two important considerations. First, patented materials must be available to the public,<sup>200</sup> but the use of patented materials is limited. The patent grants an affirmative right to the patentee to prevent others from making, using, or selling the patented invention.<sup>201</sup> Although the grant of a patent, in theory, places the patented subject matter in the public domain, making the patented materials freely available to the public, the use of such materials cannot be adverse to the patentee's rights. The *Moore* court seemed to overlook this important limitation.

Secondly, the court failed to clearly distinguish between patented materials and human biological materials. Products of nature, such as human biological materials, are not patentable subject matter under the United States Patent Law.<sup>202</sup> As discussed previously, a patented material and the human biological material from which the patented material was derived are legally and factually distinct. Also, patented material is only a part of the material necessary for important medical research.<sup>203</sup> Therefore, the *Moore* court's suggestion that the availability of patent protection increases the availability of research materials is erroneous.

The *Moore* court articulated a second reason to support its decision to refuse to extend liability. The court stated that the decision whether to extend the common-law doctrine of conversion is better left to the legislature.<sup>204</sup> The court noted that such a decision requires the gathering

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198. Biotechnology companies can protect the products of their research efforts by two methods: patents and trade secrets. Where trade secret protection is chosen, the material must be kept secret to preserve protection. U.S. CONGRESS, OFFICE OF TECHNOLOGY ASSESSMENT, NEW DEVELOPMENTS IN BIOTECHNOLOGY: U.S. INVESTMENT IN BIOTECHNOLOGY 103 (1988).

199. *Moore*, 51 Cal. 3d at 145 n.40, 793 P.2d at 495 n.40, 271 Cal. Rptr. at 162 n.40.

200. Section 112 of the United States Patent Law imposes a requirement that the specification of the patent contain a written description of the invention to enable any person skilled in the art to make and use the invention. 35 U.S.C. § 112 (1988). If the preparation of the patented subject matter can not be sufficiently described in writing, the material must be deposited in an acceptable depository. 37 C.F.R. §§ 1.801 to -.803 (1990). The fiction underlying the enablement requirement is that an inventor is granted an exclusive right of limited duration (17 years) in exchange for the disclosure of his invention to the public.

201. 35 U.S.C. § 271 (1988).

202. *Merck & Co. v. Olin Mathison Chem. Corp.*, 253 F.2d 156 (4th Cir. 1958).

203. *See supra* notes 17-19.

204. *Moore v. Regents of Univ. of Cal.*, 51 Cal. 3d 120, 147, 793 P.2d 479, 496, 271 Cal. Rptr. 146, 163 (1990).

of empirical information, the solicitation of expert advice, the holding of hearings, and the choice between complex policies.<sup>205</sup> The court also noted that the existence of statutes which govern the disposition and use of human biological materials suggests that the legislature is competent to act in this area.<sup>206</sup> The court cited an Office of Technology Assessment (OTA) Report as evidence that the United States Congress is interested in resolving the problems with respect to the use of human biological materials in research.<sup>207</sup> However, the *Moore* court did not hesitate to extend the doctrine of informed consent.

Finally, the *Moore* court relied upon the existence of an alternate theory of liability to support its conclusion. The court stressed the importance of the physician's disclosure obligation as protection for the patient, "without hindering socially useful activities."<sup>208</sup> However, as discussed above, the physician's disclosure obligation does not give the patient affirmative rights, and may be no more than a "paper tiger."<sup>209</sup>

#### IV. CONCLUSION

The California Supreme Court in *Moore* articulated a new standard of disclosure for informed consent. This new standard requires the physician to disclose his personal interests that are unrelated to the patient's health and that may affect his medical judgment.<sup>210</sup> The court implied that this disclosure obligation is sufficient to protect the patient's interest. However, the burden on the patient in proving materiality and causation renders this obligation illusory. Furthermore, it fails to recognize affirmative rights in the patient regarding a right to direct the disposition of his biological materials and a right to share in the profits gained from the use of his biological materials. Therefore, the physician's disclosure obligation is not an effective means of protecting patients from commercial exploitation.

Secondly, the *Moore* court concluded that a patient does not retain an interest in his biological materials once the materials are removed from his body.<sup>211</sup> Based upon this conclusion, the court held that Moore could not maintain a cause of action for conversion.<sup>212</sup> The most important aspect of this holding is the implication that the patient, whose

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205. *Id.*

206. *Id.*

207. *Id.* See OTA REPORT, *supra* note 6. Congress may have decided not to act in this area and to allow the common law and the courts to resolve the disputes.

208. *Moore*, 51 Cal. 3d at 147, 793 P.2d at 497, 271 Cal. Rptr. at 164.

209. *Id.* at 180, 793 P.2d at 520, 271 Cal. Rptr. at 187 (Mosk, J., dissenting).

210. *Id.* at 131-32, 793 P.2d at 485, 271 Cal. Rptr. at 152.

211. *Id.* at 137, 793 P.2d at 489, 271 Cal. Rptr. at 156.

212. *Id.* at 147, 793 P.2d at 497, 271 Cal. Rptr. at 164.

biological materials are the basis of the discovery, has no rights with respect to the products of the research. The patient also does not have a right to share in the profits.

The court's decision is a victory for the biotechnology industry. The *Moore* court effectively limits liability to only those persons in a fiduciary relationship with the patient. Biotechnology companies are free to use human biological materials without the threat of litigation should the patient discover that his biological materials were the basis for the development of commercial products. However, it is not clear whether a state that is more interested in protecting the patient's rights than in protecting biotechnology researchers and industry will reach the same result.

The primary lesson of *Moore* is to recognize the importance of full disclosure to the patient. Proper disclosure should include: (1) a brief discussion informing the patient of the physician's plans to use the patient's biological materials in research; (2) whether such use will benefit the patient, physician, or anyone in the future; (3) the purpose for using the materials in research; and (4) the likelihood that such research use will lead to a commercial product. By disclosing this information, the physician will satisfy his fiduciary duty of disclosure and the new standard of disclosure for informed consent. In addition, when the physician properly obtains the patient's consent for the use of his biological materials, the physician will preclude a conversion action. With proper planning and consideration of the patient's rights and interests, the *Moore* case will never be repeated.

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## **Certification of Specialization: Another Limit on Attorney Advertising is *Peeled* Away**

Specialization is a way of life in our highly complex society. Individuals from carpenters to medical professionals specialize and communicate their fields of expertise to the public. The legal profession, however, has been slow to formally acknowledge its members as “specialists.” In fact, the American Bar Association (ABA) Model Rule of Professional Conduct 7.4, which has been adopted by over half the states, specifically forbids attorneys from holding themselves out as “specialists.”<sup>1</sup> This prohibition stems from the fear that this type of advertising may potentially mislead consumers by implying superior quality services or formal recognition. These fears, however, could be minimized by formally certifying lawyers as specialists and providing for the effective use of specialty advertising to better inform the public of the availability of legal services.

The United States Supreme Court decision in *Peel v. Attorney Registration and Disciplinary Commission of Illinois*<sup>2</sup> marks a significant point of intersection between two lines of developing trends in the legal profession: attorney advertising and certification of specialization. At issue in the *Peel* case was whether the Supreme Court of Illinois acted consistently with the first amendment<sup>3</sup> when it censured an attorney for stating on his professional letterhead that he was certified as a civil trial specialist by the National Board of Trial Advocacy (NBTA).<sup>4</sup> In a five to four decision, the Court concluded that “a lawyer has a constitutional right, under the standards applicable to commercial speech, to advertise

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1. Model Rules of Professional Conduct Rule 7.4 (1989) reads:

A lawyer may communicate the fact that the lawyer does or does not practice in particular fields of law. A lawyer shall not state or imply that the lawyer is a specialist except as follows:

(a) a lawyer admitted to engage in patent practice before the United States Patent and Trademark Office may use the designation “Patent Attorney” or a substantially similar designation;

(b) a lawyer engaged in Admiralty practice may use the designation “Admiralty,” “Proctor in Admiralty” or a substantially similar designation; and

(c) (provisions on designation of specialization of the particular state).

2. 110 S. Ct. 2281 (1990).

3. “Congress shall make no law . . . abridging the freedom of speech, or of the press. . . .” U.S. CONST. amend. I.

4. The letterhead actually appeared as follows:

Gary E. Peel

Certified Civil Trial Specialist

By the National Board of Trial Advocacy Licensed: Illinois, Missouri, Arizona

his or her certification as a trial specialist by NBTA.<sup>5</sup> In the deciding vote, however, Justice Marshall insisted that this did not preclude regulation and that each state could choose for itself, within first amendment constraints, the best regulatory method to protect against potentially misleading claims.<sup>6</sup>

The *Peel* decision recognizes the significance of the NBTA as a private certification group, removes another limitation on attorney advertising, and makes it incumbent upon each state to reevaluate its current regulatory scheme to ensure that it does not run afoul of the first amendment. The *Peel* decision also has important implications for attorneys and consumers. *Peel* recognizes an attorney's right to specialize and to communicate that specialty to the community. From the perspective of the consumer, the *Peel* decision means that the public will be entrusted with more information about lawyers and their expertise from which to make informed decisions. The quantity and quality of this new information will depend largely upon which method of regulation a state adopts.

This Note examines the impact of the *Peel* decision on states that place an absolute ban on attorney communication of certified specialties and suggests alternatives that may be used to regulate advertising of certification of specialization. Part I reviews the development of specialty certification within the legal profession and the development of the line of cases extending the rights of lawyers to advertise. Part II analyzes the *Peel* decision and its implications for states that have adopted ABA Model Rule 7.4 which flatly bans the communication of specialties. Part III evaluates a continuum of alternatives for regulating the advertisement of certification of specialization. Part IV concludes that state adoption of the ABA Model Plan of Specialization<sup>7</sup> will provide consumers with access to legal services, prevent misleading advertising, and promote competence in the profession within first amendment constraints.

## I. DEVELOPMENT

### A. Certification of Specialization

Quite distinct from the English system of solicitors and barristers, American law took the renaissance approach of one lawyer capable of performing all legal tasks. However, as the law became increasingly complex, public demand for expertise on the part of the lawyer brought

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5. *Peel*, 110 S. Ct. at 2287-93.

6. *Id.* at 2296 (Marshall, J., concurring).

7. See ABA MODEL PLAN OF SPECIALIZATION (1979) (reprinted in the Appendix).

about de facto specialization within the legal profession.<sup>8</sup> Throughout this century, specialization among lawyers has expanded at an increasing rate. More than eighty years ago, the ABA, in the Canons of Professional Ethics, recognized and allowed communication of certain "branches of the profession."<sup>9</sup> Throughout the 1950's, the ABA debated the issue of recognition and regulation of specialties and concluded that the issue should be handled at the state level, rather than on a national level.<sup>10</sup> The basis for advocating state regulation is that each jurisdiction is in the best position to regulate its own bar.<sup>11</sup> De facto specialization continued to proliferate without formal recognition or regulation on state and national levels.

In 1973, Chief Justice Warren E. Burger advanced the proposition that "specialized training and certification of trial advocates is essential to the American system of justice."<sup>12</sup> The address warned that "lawyers, like people in other professions, cannot be equally competent for all tasks in our increasingly complex society and increasingly complex legal system in particular."<sup>13</sup> In response to this call, proponents of specialization founded the NBTA in 1977.<sup>14</sup> The NBTA developed a rigorous set of standards and procedures to ensure that certified members possess the skills and experience necessary to vigorously advocate in the courtroom.<sup>15</sup> Other certification programs developed as lawyers began to

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8. N. ROSEN, *LAWYER SPECIALIZATION* 2 (1990) (quoting 79 ABA REP. 582, 584 (1954)).

9. *Id.* at 1-2. Canon 27 provided that lawyers could advertise and include a "law list" of the "branches of the profession" in which they practiced. Canon 32 allowed lawyers to be included in a law list if it was not deceptive. Canon 46 provided that lawyers could notify other lawyers of their availability to act as associates in a particular branch of the law. *Id.*

10. *Id.* at 2.

11. ABA STANDING COMMITTEE ON SPECIALIZATION, *HANDBOOK ON SPECIALIZATION* 28 (1983) [hereinafter ABA HANDBOOK].

12. Burger, *The Special Skills of Advocacy: Are Specialized Training and Certification of Advocates Essential to Our System of Justice?*, 42 FORDHAM L. REV. 227, 229 (1973) (recording the fourth annual John F. Sonnet Memorial Lecture delivered on November 26, 1973).

13. *Id.*

14. The groups sponsoring NBTA include the National District Attorneys Association, the Association of Trial Lawyers of America, the International Academy of Trial Lawyers, the International Society of Barristers, the National Association of Criminal Defense Lawyers, the National Association of Women Lawyers, and the American Board of Professional Liability Attorneys. *Peel v. Attorney Registration & Disciplinary Comm'n*, 110 S. Ct. 2281, 2284 n.3 (1990).

15. Brief for National Board of Trial Advocacy as Amicus Curiae at 9-13, *Peel v. Attorney Registration & Disciplinary Comm'n*, 110 S. Ct. 2281 (1990).

The current NBTA requirements are that an applicant: (1) be a bar member in

confine their practices and expertise to specialized areas of law.<sup>16</sup>

By 1978, four states began experiments in state certification programs.<sup>17</sup> These programs were voluntary, and the attorneys were not restricted to practice only in the area of specialization. Florida and New Mexico took the self-designation approach.<sup>18</sup> These plans permitted lawyers to designate areas in which they practice, but did not guarantee the expertise of the lawyer.<sup>19</sup> In Florida, this consisted of each attorney claiming his own specialty, substantiated by three years of practice in the specialty area, thirty hours of Continuing Legal Education (CLE), and statements of reference confirming involvement.<sup>20</sup> The Florida plan approved twenty-six fields of practice and allowed an attorney to advertise up to three areas of practice upon designation.<sup>21</sup> The emphasis in the Florida and New Mexico self-designation plans was to inform the public of attorneys' specialties, rather than to confirm competence.

California and Texas undertook pilot state operated certification programs designed to assure a certain level of competence through comprehensive evaluation of qualifications prior to certification. Unlike self-designation, these plans established state operated specialization pro-

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good standing; (2) disclose any misconduct including criminal convictions or professional discipline; (3) show at least five years of actual practice in civil trial law during the period immediately preceding application for certification; (4) show substantial involvement in trial practice, including 30% of professional time in civil trial litigation during each of the five years preceding application; (5) demonstrate experience by appearing as lead counsel in at least 15 complete trials of civil matters to verdict or judgment, including at least 45 days of trial and 5 jury trials, and by appearing as lead counsel in 40 additional contested matters involving the taking of testimony; (6) participate in 45 hours of continuing legal education in civil trial practice in the 3 years preceding application; (7) be confidentially reviewed by six attorneys, including two against or with whom the applicant has tried a civil matter, and a judge before whom the applicant has appeared within the preceding two years; (8) provide a substantial trial court memorandum or brief that was submitted to a court in the preceding three years; and (9) pass a day-long written examination testing both procedural and substantive law in various areas of civil trial practice.

*Peel*, 110 S. Ct. at 2285 n.4.

16. The NBTA, in addition to certification for civil trial specialists, developed certification for the criminal trial specialist. However, certification by other private groups has not occurred, leaving the NBTA as the only private national group which offers certification to its members.

17. These states are: California (1971), Florida (1975), New Mexico (1973), and Texas (1974). Zehnle, *Specialization in the Legal Profession: An Analysis of Current Proposals*, in *LEGAL SPECIALIZATION* 22-25 (1976).

18. ABA HANDBOOK, *supra* note 11, at 12.

19. *Id.*

20. ABA Standing Committee on Specialization, *Specialization in Florida*, 3 SPECIALIZATION UPDATE 1, 2 (Feb. 1990).

21. ABA HANDBOOK, *supra* note 11, at 12.

grams and limited certification exclusively to those specialties.<sup>22</sup> The Texas plan required that the attorney have at least five years of full-time practice, spend at least twenty-five percent of his or her practice time in the specialty area, provide favorable statements of reference from attorneys and judges, demonstrate satisfactory participation in CLE, and pass a comprehensive six hour examination prior to certification.<sup>23</sup> Additionally, these state certification plans required recertification every five years to assure on-going competence. These plans recognized that de facto specialization already existed within the legal profession and that a centralized method of evaluation before certification would not only assist the public in choosing qualified attorneys, but would also increase professional competence.

Certification programs proliferated in response to the profession's need to guarantee competence in specialized areas of law and the public's need for accurate information for decisionmaking. The ABA established the Standing Committee on Specialization and developed the ABA Model Plan of Specialization to assist states in establishing certification programs.<sup>24</sup> By 1986, two states recognized the designation of "Certified Civil Trial Specialist" by the NBTA and developed procedures for approving plans from other private certification groups.<sup>25</sup> Gradually, other states developed or adopted certification programs to protect the public and promote legal proficiency.<sup>26</sup> Florida and New Mexico recognized the importance of centralized methods to confirm competence prior to certification and instituted state operated programs to gradually replace the earlier efforts in self-designation programs.<sup>27</sup>

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22. California began certification in the following three areas: (1) criminal law; (2) workman's compensation; and (3) taxation. Zehnle, *supra* note 17, at 22. Texas began certification in three areas: (1) criminal law; (2) family law; and (3) labor law. McNeil, *Specialization in Texas*, 1 SPECIALIZATION UPDATE 1, 2 (Mar. 1989). Since that time, California has expanded its plan to include family law, immigration and nationality law, probate, estate planning, and trust law. Texas has expanded its plan to include 13 areas of certification: administrative law, civil appellate law, civil trial law, consumer bankruptcy law, criminal law, estate planning and probate law, family law, immigration and nationality law, labor law, oil, gas and mineral law, personal injury, trial law, tax law, and real estate law. ABA Standing Committee on Specialization, Status Report on State Specialization Plans (Apr. 1991) [hereinafter Status Report] (available from the ABA Standing Committee on Specialization).

23. McNeil, *supra*, note 22, at 2.

24. ABA HANDBOOK, *supra* note 11, at 16.

25. *Ex parte Howell*, 487 So. 2d 848, 851 (Ala. 1986); *In re Johnson*, 341 N.W.2d 282, 283 (Minn. 1983).

26. These states are: Arkansas (1982), California (1971), Connecticut (1981), Florida (1974), Louisiana (1983), New Jersey (1980), New Mexico (1973), North Carolina (1982), South Carolina (1981), and Texas (1975). Status Report, *supra* note 22, at 1-9.

27. Certification programs were adopted in Florida in 1982 and in New Mexico in 1987. *Id.* at 2-7.

Today, certification programs have evolved into two types: state approval of outside agency certification plans, such as the NBTA, and state operated certification plans. Four states recognize private certification groups and have procedures for approval.<sup>28</sup> Eleven states have their own certification programs,<sup>29</sup> five of which have adopted plans based on the ABA Model Plan of Specialization.<sup>30</sup> The remaining states have no established certification process. Irrespective of formal certification plans, the fact remains that specialization is a way of life in the legal profession. Currently, 206 fields of law, from administrative to zoning, are recognized and published in a national directory of lawyers who hold themselves out as specializing or concentrating in specific areas of practice.<sup>31</sup> The time is ripe to recognize specialization and to plan intelligently for its regulation and use in attorney advertising.

### B. Attorney Advertising

Attorney advertising has its point of origin in *Bates v. State Bar of Arizona*,<sup>32</sup> which opened the door to allow first amendment protection of truthful legal advertising. *Bates* involved two attorneys who truthfully advertised in a newspaper the availability and terms of routine legal services. The Supreme Court, relying on an earlier decision, *Virginia State Board of Pharmacy v. Virginia Citizens Consumer Council, Inc.*,<sup>33</sup> determined that blanket suppression of attorney advertising "serves to inhibit the free flow of commercial information and to keep the public in ignorance."<sup>34</sup> The Court held that this total ban was violative of the

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28. These states are: Alabama, Connecticut, Georgia, and Minnesota. *Id.* at 1-5.

29. These states are: Arizona, Arkansas, California, Florida, Louisiana, New Jersey, New Mexico, North Carolina, South Carolina, Texas, and Utah. *Id.* at 1-10.

30. These states are: Arkansas, New Jersey, New Mexico, North Carolina, and Utah. *Id.* at 1-11.

31. LAWYER'S REGISTER PUBLISHING CO., LAWYER'S REGISTER BY SPECIALTIES AND FIELDS OF LAW 2 (9th ed. 1988).

32. 433 U.S. 350 (1977).

33. 425 U.S. 748 (1976). Prior to this case, "the commercial speech doctrine" excepted professional advertising from protection under the first amendment. *Valentine v. Chrestensen*, 316 U.S. 52 (1942). *Virginia State Board of Pharmacy* dealt with the issue of whether a pharmacist's advertisement of prices on prescription drugs falls within the protection of the first amendment. The court determined that commercial speech which is not misleading is entitled to at least limited protection under the first amendment. This signaled the beginning of free commercial speech and the demise of the "commercial speech doctrine." See Note, *The Demise of the Commercial Speech Doctrine and the Regulation of Professional's Advertising: The Virginia Pharmacy Case*, 34 WASH. & LEE L. REV. 245 (1977).

34. *Bates*, 433 U.S. at 365.

first amendment, but carefully pointed out that this did not preclude other regulation.<sup>35</sup>

*Bates* established a two-part framework for evaluating attorney advertising cases. First, the Court scrutinized the advertisement itself to determine whether the claims were misleading. "Advertising that is false, deceptive, or misleading of course is subject to restraint."<sup>36</sup> The *Bates* Court determined that truthful printed advertising of the price and terms of routine legal services is not misleading on its face, and thus, is not subject to blanket suppression.<sup>37</sup> The Court, however, declined to address claims of quality, noting that such claims were "not susceptible of precise measurement or verification and . . . might well be deceptive or misleading to the public."<sup>38</sup> The second part of the analysis balanced the state's interests in restricting advertising against the right to the free flow of commercial speech.<sup>39</sup> This balancing test runs throughout the attorney advertising cases. In *Bates*, the Court upheld the right of the public to the free flow of information based on first amendment considerations of commercial speech and recognized that attorney advertising serves a vital societal interest in providing information for informed decisionmaking.<sup>40</sup> The expansive approach taken by the *Bates* Court in applying first amendment protection to attorney advertising began a line of cases cutting back limits on restricting attorney advertising.

*Ohralik v. Ohio State Bar Association*<sup>41</sup> and its companion case, *In re Primus*,<sup>42</sup> drew a distinction between advertising and solicitation. Advertising in printed media is afforded some first amendment protection, whereas in-person solicitation for pecuniary gain is so potentially "over-reaching" that it warrants prohibition by the state.<sup>43</sup> The Court reasoned that the consumer is adequately protected when printed material can be used or discarded at will.<sup>44</sup> However, when the attorney solicits in-person, the consumer is in an unequal bargaining position and requires pro-

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35. *Id.* at 383.

36. *Id.*

37. *Id.* at 382.

38. *Id.* at 366.

39. *Id.* at 368-79. The State in *Bates* set forth six major interests: the adverse effect on professionalism, the inherently misleading nature of attorney advertising, the adverse effect on the administration of justice, the undesirable economic effects of advertising, the adverse effect of advertising on the quality of service, and the difficulties of enforcement. None of these state interests persuaded the Court that an outright ban was justified.

40. *Id.* at 364.

41. 436 U.S. 447 (1978).

42. 436 U.S. 412 (1978).

43. *Id.* at 439.

44. *Id.* at 435-36.

tection.<sup>45</sup> The *Primus* Court concluded that solicitation by letter on behalf of a nonprofit, public interest group is not overreaching.<sup>46</sup> In *Ohralik*, the Court held that because the attorney's in-person solicitation of an auto accident victim in the hospital was overreaching and because there would be great difficulty in regulating in-person solicitation, the state was justified in prohibiting the conduct.<sup>47</sup> These cases scrutinized the advertising media and determined that "overreaching" forms of communication, such as in-person solicitation, justify a categorical prohibition by the state.

The Court in *In re R.M.J.*<sup>48</sup> further refined the two-part analysis of *Bates* by considering the misleading aspects of advertising fields of practice and by applying the four-part analysis set forth in *Central Hudson Gas & Electric Corp. v. Public Service Commission*<sup>49</sup> to weigh the state interest. The Court first considered whether advertising that deviates from the state's law list is misleading or deceptive.<sup>50</sup> It determined that use of nondeceptive terminology to describe fields of practice (e.g., "property" instead of "real estate"), is not misleading.<sup>51</sup> The Court based this determination on the fact that the public could easily understand these terms, but cautioned that claims of quality are not so easily verifiable and may be "so likely to mislead as to warrant restriction."<sup>52</sup> The Court expanded on the inquiries into the state's justifiable interest in regulating the speech by asking whether the state's interest was substantial, whether the restriction advanced the state's interest, and whether less restrictive means were available to regulate the speech.<sup>53</sup> The *R.M.J.* Court concluded that, because deviation from

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45. *Id.*

46. *Id.* at 439.

47. *Ohralik v. Ohio State Bar Ass'n*, 436 U.S. 447, 467 (1978).

48. 455 U.S. 191 (1982).

49. 447 U.S. 557 (1980). The exact test was set out as follows:

In commercial speech cases, then, a four part analysis has developed. At the outset, we must determine whether the expression is protected by the First Amendment. For commercial speech to come within that provision, it at least must concern lawful activity and not be misleading. Next, we ask whether the asserted governmental interest is substantial. If both inquiries yield positive answers, we must determine whether the regulation directly advances the governmental interest asserted, and whether it is not more extensive than is necessary to serve that interest.

*Id.* at 566.

50. *Id.* Missouri Supreme Court Rule 4 provided a list of 23 fields of law which could be advertised, but deviation from the exact phraseology of the law list was not permitted. Mo. S. Ct. RULE 4, addendum III (1977).

51. *In re R.M.J.*, 455 U.S. at 205.

52. *Id.* at 201 (quoting *Bates v. State Bar of Arizona*, 433 U.S. 350, 383-84 (1977)).

53. *Id.* at 203-07.

the state law list was not misleading and no substantial interest was promoted by the restriction, the state was not justified in restricting the advertising.<sup>54</sup> Further, although mailings and handbills are more difficult to supervise than newspaper advertisements, this did not substantiate the state's interest in unduly restricting the flow of information.<sup>55</sup> This decision opened the door to lawyer listing and advertising by field of law as long as it is not misleading and added the constitutional restriction that states employ the least restrictive means to protect the public from misleading or overreaching advertising.

*Zauderer v. Office of Disciplinary Counsel*<sup>56</sup> added targeted newspaper advertising and the use of illustrations to the permissible types of advertising and recognized the dangers associated with use of disclosures in regulating commercial speech. *Zauderer* involved the use of an illustration depicting the dangers of the Dalkon Shield in a newspaper advertisement to target those injured by the device. The *Zauderer* Court determined that targeting persons with specific legal needs (e.g., users of the Dalkon Shield), is not overreaching when accomplished by newspaper and the use of truthful illustrations is not misleading.<sup>57</sup> Such advice serves a useful public service in reaching and informing persons who may otherwise remain ignorant of their legal rights and of the health hazards associated with the device.<sup>58</sup> The Court's focus then shifted to the means of restricting the advertising. The Court analyzed the use of disclosures as a means of regulation and warned that unduly burdensome requirements may have a chilling effect on protected commercial speech.<sup>59</sup> The Court reasoned that requiring the disclosures to be "reasonably related to the State's interest" is sufficient to protect against over-regulation.<sup>60</sup> In allowing truthful targeted newspaper advertising, *Zauderer* paved the way for targeted direct mail.

*Shapero v. Kentucky Bar Association*<sup>61</sup> directly addressed the use of targeted direct mail and invalidated the distinction between advertising and printed solicitation. Targeted direct mail was classified as solicitation and was absolutely prohibited by Kentucky Supreme Court Rule 3.135(5)(b)(i).<sup>62</sup> The Court determined that there was nothing misleading

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54. *Id.* at 205.

55. *Id.* at 206.

56. 471 U.S. 626 (1985).

57. *Id.* at 647.

58. *Id.* at 634.

59. *Id.* at 662-64.

60. *Id.* at 651.

61. 486 U.S. 466 (1988).

62. Kentucky Supreme Court Rule 3.135(5)(b)(i) (1988) provided:

A written advertisement may be sent or delivered to an individual addressee

in the letters and that a printed letter, unlike in-person solicitation, could be easily cast away and was, therefore, not overreaching.<sup>63</sup> Because the speech was not misleading or overreaching, the distinction between solicitation and advertising was immaterial.<sup>64</sup> Turning to the issue of regulation, the Court determined that the state could regulate in less restrictive ways than a total prohibition. Alternatives to total prohibition include the use of disclaimers identifying the mail as an advertisement or informing the recipient how to report misleading letters. In addition, disciplinary agencies could screen letters and require verification by the attorney.<sup>65</sup> The Court concluded that the free flow of commercial information justifies the added burden of regulation, rather than an absolute prohibition.<sup>66</sup>

From this line of cases developed both factual and legal guidelines. From the factual viewpoint, truthful printed advertising of legal prices, terms, fields of practice, and illustrations whether by newspaper, flyer, or letter, is not inherently misleading. Claims of quality, however, are not easily verifiable or measurable and are potentially misleading. Targeting specific groups or persons in print is not overreaching, whereas in-person solicitation for pecuniary gain is inherently overreaching because the trained advocate and the consumer are in unequal bargaining positions. From a legal perspective, truthful attorney advertising is protected under the first amendment and cannot be subjected to absolute prohibition. However, because some forms of legal advertising are potentially

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only if that addressee is one of a class of persons, other than a family, to whom it is also sent or delivered at or about the same time, and only if it is not prompted or precipitated by a specific event or occurrence involving or relating to the addressee or addressees as distinct from the general public.

Compare the Kentucky rule with ABA Model Rule of Professional Conduct Rule 7.3 (1984):

A lawyer may not solicit professional employment from a prospective client with whom the lawyer has no family or prior professional relationship, by mail, in-person or otherwise, when a significant motive for the lawyer's doing so is the lawyer's pecuniary gain. The term "solicit" includes contact in-person, by telephone or telegraph, by letter or other writing, or by other communication directed to a specific recipient, but does not include letters addressed or advertising circulars distributed generally to persons not known to need legal services of the kind provided by the lawyer in a particular matter, but who are so situated that they might in general find such services useful.

Both the Kentucky and ABA rules categorically prohibit targeted direct mail solicitation by lawyers for pecuniary gain. Neither requires a finding of false or misleading solicitation.

63. *Shapero*, 486 U.S. at 475-76.

64. See Note, *After Shapero v. Kentucky Bar Association: Much Remains Unresolved About The Allowable Limits Of Restrictions On Attorney Advertising*, 61 U. COLO. L. REV. 115, 134 (1990).

65. *Shapero*, 486 U.S. at 485-86.

66. *Id.* at 478.

misleading or overreaching, the state has a justifiable interest in regulating commercial speech, but regulation must be in furtherance of the state's interest in protecting consumers and must be accomplished with the least restrictive means.

## II. THE *PEEL* DECISION

The *Peel* decision relied on the two-part analysis set forth in earlier attorney advertising cases to examine the intersection of the attorney advertising line of cases with the specialty certification line of development. The first level of inquiry, whether the advertising is free from misleading claims to be afforded the protection of the first amendment, produced three distinct views from the Court. The plurality recognized the significance of NBTA certification and determined that Peel's "letterhead was neither actually nor inherently misleading."<sup>67</sup> Justice O'Connor concluded in a dissenting opinion that the letterhead was inherently misleading.<sup>68</sup> Justice Marshall, in his concurring opinion, and Justice White, in his dissenting opinion, provided a middle ground and determined that although the letterhead was not actually misleading, it was potentially misleading.<sup>69</sup> Considered as a whole, these opinions yield the conclusion that NBTA certification is to be afforded at least limited first amendment protection.

The second level of analysis focused on balancing state interests in preventing misleading claims with the first amendment rights of the attorney and the public to the free exchange of information regarding certification of specialty. This analysis produced equally disparate views from the Court. The plurality determined that the state's interest in protecting against the possibility of deception does not "rebut the constitutional presumption favoring disclosure over concealment."<sup>70</sup> NBTA certification was verifiable and the attorney and the public had a right under the first amendment to free commercial speech with regard to NBTA certification.<sup>71</sup> The dissent concluded that states should be allowed to ban NBTA certification because requiring them to regulate certification is unduly cumbersome and is not required by the Constitution.<sup>72</sup> Justice Marshall solved the dilemma by insisting that because the letterhead had the potential to mislead consumers, states retained the right to regulate,

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67. *Peel v. Attorney Registration & Disciplinary Comm'n*, 110 S. Ct. 2281, 2293 (1990).

68. *Id.* at 2299 (O'Connor, J., dissenting).

69. *Id.* at 2293, 2297 (Marshall, J., concurring; White, J., dissenting).

70. *Id.* at 2293.

71. *Id.* at 2288-89.

72. *Id.* at 2301 (O'Connor J., dissenting).

but not absolutely prohibit, communication of NBTA certification.<sup>73</sup> Realizing that the decision in the case would have implications on advertising, certification, and state regulation, the Court carefully scrutinized the role of certification and state regulation in preventing misleading claims.

#### *A. Advertising and Specialty Certification*

The implications of the *Peel* decision are yet to be felt. Viewed from the advertising perspective, the decision extends the *Bates* line of cases by adding specialty certification to the list of permissible types of attorney advertising. The effect of the *Bates* decision on legal advertising provides a basis to conclude that the *Peel* decision will not open the floodgates of certification advertising. After *Bates*, the legal profession proceeded cautiously in its use of advertising. In fact, "3 percent of lawyers advertised in 1978, 13 percent in 1984, 24 percent in 1985, and in 1986, 32 percent."<sup>74</sup> Advertising of specialty certification is likely to take a similar course as attorneys test the waters to determine what each state will allow and what significance the public attaches to certification of specialized fields of practice.

From the certification viewpoint, *Peel* recognizes both the benefits and dangers associated with communication of certification. The plurality recognized the benefits of NBTA certification and the importance of encouraging specialty certification programs.<sup>75</sup> It noted that NBTA certification as a trial specialist requires strict adherence to "objective and demanding" standards and procedures developed and approved by leading legal authorities, including judges, scholars, and practitioners.<sup>76</sup> The Court noted that "a certification of specialty by NBTA would indicate a level of expertise with regard to trial advocacy in excess of the level of expertise required for admission to the bar generally."<sup>77</sup> The Court further acknowledged that truthful disclosure of NBTA certification "serves the public interest and encourages the development and utilization of meritorious certification programs for attorneys."<sup>78</sup> In recognizing the positive values of this private certification group, the Court provided each state with a model program for ensuring professional competence and providing the public with accurate information on legal specialization.

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73. *Id.* at 2296 (Marshall J., concurring).

74. Sawaya, *Willy Loman Joins the Bar*, 76 A.B.A. J. 88 (Oct. 1990).

75. *Peel v. Attorney Registration & Disciplinary Comm'n*, 110 S. Ct. 2281, 2284-85 (1990).

76. *Id.*

77. *Id.* at 2285 (quoting *Ex parte Howell*, 487 So. 2d 848, 851 (Ala. 1986)).

78. *Id.* at 2293.

Although the plurality concluded that NBTA certification was verifiable and consumers should be free to infer for themselves the degree of quality that flows from an evaluation of NBTA requirements,<sup>79</sup> the Court recognized that states have an interest in protecting the public from hollow claims by bogus certification groups.<sup>80</sup> Both the concurring and dissenting opinions expressed concerns over the dangers of misleading the public through recognition of NBTA certification and the implied quality claims that the public may attach to such certification.<sup>81</sup>

Both the dissenting and concurring opinions hypothesized that without formal state recognition, advertising certification by the NBTA could be misconstrued by consumers to be certification by the government. This potentially misleading information could be derived in two ways. First, because the certification was from the "National" Board of Trial Advocacy, consumers could believe that the designation was from a federal program.<sup>82</sup> Second, because all states license attorneys and some states certify attorneys, the public could be misled into the belief that all certification programs are recognized by the state.<sup>83</sup> In response, the plurality maintained that the public knows the difference between state "licensing" and private "certification."<sup>84</sup> The entire Court, however, based this line of reasoning on tenuous interpretations of dictionary meanings and not empirical studies of the public's perception of the terms "national," "license," and "certification." Assuming, *arguendo*, that the public may be misled by NBTA certification, Justice Marshall correctly noted that the problem of distinguishing between government and private certification may be easily cured through the use of a disclaimer.<sup>85</sup>

Not so easily dispelled by mere use of a disclaimer is the concern that designation as a "specialist" might mislead consumers through implied claims of quality. Although advertising of certification as a specialist does not itself make a claim of quality, it naturally implies superior services. ABA studies, relied on by the entire Court, have shown that the public believes that the term "specialist" implies better services.<sup>86</sup> Because certification as a specialist implies superior skills, certifying

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79. *Id.* at 2288.

80. *Id.* at 2292.

81. *Id.* at 2293 (Marshall J., concurring); *id.* at 2297 (White J., dissenting); *id.* at 2298 (O'Connor J., dissenting).

82. *Id.* at 2294 (Marshall J., concurring).

83. *Id.* at 2300 (O'Connor J., dissenting).

84. *Id.* at 2289.

85. *Id.* at 2296 (Marshall, J., concurring).

86. ABA STANDING COMMITTEE ON SPECIALIZATION, A SURVEY ON HOW THE PUBLIC PERCEIVES A SPECIALIST, INFORMATION BULLETIN #10 (1988).

groups requiring little more than mere payment of fees present the danger of misleading the public into the belief that the specialist has achieved an adequate level of competence. Because the public perception of a specialist is one with superior expertise, it is imperative that states regulate the advertising of certified specialists in a manner that adequately informs the public of the specialized skills attained through certification.<sup>87</sup>

The *Peel* decision tactfully evades an outright endorsement of certification programs as a means of preventing misleading claims while remaining within first amendment confines. It does, however, recognize the benefits of NBTA certification. The Court noted that state screening of certification programs may minimize the dangers associated with specialization advertising and that many states already recognize certification programs and allow attorneys to advertise their certification to the public.<sup>88</sup> This recognition and the decision to allow communication of specialty certification may provide the impetus for other legal specialty organizations to develop programs to certify their members. *Peel* opens the door to formal recognition of specialty certification, adds certification to the list of advertising forms which are not inherently misleading, and suggests alternative schemes of state regulation to prevent potentially misleading claims of certification.

### B. State Regulation

The *Peel* decision compels each state to reevaluate its current regulatory scheme and decide for itself the least restrictive method of regulating the advertisement of certification of specialization. The plurality favored state recognition of bona fide certification programs and suggested that this could be accomplished through screening private certification groups.<sup>89</sup> The dissent, however, opposed this method because it is unduly burdensome and not required by the Constitution.<sup>90</sup> The plurality mediated these positions by suggesting that an alternative to state sanctioning of certification programs is to require the advertising to carry a disclaimer or disclosure.<sup>91</sup> This latter view recognizes the states' role in regulating their own bars and the political and constitutional ramifications of requiring states to adopt certification programs. Whichever method the state chooses, it should be mindful that the Court favors disclosure over concealment.

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87. *Peel v. Attorney Registration & Disciplinary Comm'n*, 110 S. Ct. 2281, 2295-96 (1990) (Marshall, J., concurring).

88. *Id.* at 2288 & n.11.

89. *Id.* at 2293.

90. *Id.* at 2301 (O'Connor, J., dissenting).

91. *Id.* at 2292.

The policy of favoring disclosure over concealment finds support in two negative inferences. First, the converse policy of favoring concealment of information from the consumer presupposes that the public is inherently ignorant.<sup>92</sup> The dissent surmised that "the public lacks sophistication concerning legal services."<sup>93</sup> The plurality opinion chose instead to "reject the paternalistic assumption that the recipients of [the] petitioner's letterhead [were] no more discriminating than the audience for children's television."<sup>94</sup> This analogy by the plurality may be overly general because, in legal advertising, both the audience and the product are more sophisticated than children's television advertising. However, the plurality view correctly elevates the consumer of legal services to a level of knowledge consistent with today's informed society. Second, the plurality recognized that use of an absolute prohibition to ban communication of NBTA certification is undermined by the ad hoc approach of excepting certain specialties such as "Registered Patent Attorney" and "Proctor in Admiralty," which pose the same risk of deception.<sup>95</sup> If the concern is for the consumer, the policy of favoring disclosure over concealment provides more information on which to make decisions. Thus, regulation, not prohibition, best serves the public.

Currently, twenty-seven states and the District of Columbia ban lawyer certification advertising and will be directly affected by the *Peel* decision.<sup>96</sup> Most of these states have modeled their rules dealing with advertising of certified specialty after the ABA Model Rule of Professional Conduct 7.4 which prohibits a lawyer from stating or implying that the lawyer is a specialist except for patent, trademark, or admiralty.<sup>97</sup> *Peel* suggests that this group of states relax the outright ban and implement alternative regulatory schemes to guard against the possibility of misleading the public into believing that the designation of certified specialist implies superior services or that the state has certified the lawyer as a specialist. The *Peel* decision requires all states with rules modeled after ABA Rule 7.4 or its predecessor DR 2-105,<sup>98</sup> to modify

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92. *Id.* at 2290 n.13.

93. *Id.* at 2300 (O'Connor, J., dissenting) (quoting *Bates v. State Bar of Arizona*, 433 U.S. 350, 383 (1977)).

94. *Id.* at 2290.

95. *Id.* at 2291.

96. These states are: Alaska, Colorado, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Kentucky, Maine, Maryland, Massachusetts, Mississippi, Missouri, Nebraska, Nevada, New Hampshire, New York, Ohio, Oregon, Pennsylvania, South Dakota, Tennessee, Vermont, Virginia, Washington, West Virginia, and Wisconsin. Gibbons, *The Right to Specialize*, 76 A.B.A. J. 56, 59 (May 1990).

97. See *supra* note 1.

98. Model Code of Professional Responsibility Disciplinary Rule 2-105 (1977) pro-

their rules to regulate, rather than prohibit, advertising of certification of specialization.

The *Peel* decision indirectly affects the remaining states by forcing them to evaluate their current regulations on advertising of certification of specialization. The eleven states that maintain certification plans will need to determine whether to recognize private certification programs. Failure to recognize these programs could sound the death knell for private certifying groups by decreasing the incentive for affiliation. This is a counterproductive result because these groups supply "powerful professional and economic incentives to increase competence"<sup>99</sup> and provide a uniform national standard. The seven states with no ban on advertising of certification of specialization need to consider the advantages offered by certification programs in assuring minimum levels of competence of members of the bar.<sup>100</sup> Least affected by the decision are the four states which already have systems to approve private specialty certification programs.<sup>101</sup> Although the *Peel* decision affects states in varying degrees, the Court's positive recognition of NBTA certification deserves evaluation by each state.

### III. REGULATING CERTIFIED SPECIALIST ADVERTISING

#### A. *Method of Evaluation*

In contemplating which method of regulation to adopt, states should first consider the goals of regulating specialty certification advertising.

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vides:

(A) A lawyer shall not hold himself out publicly as a specialist, as practicing in certain areas of the law or as limiting his practice . . . except as follows:

(1) A lawyer admitted to practice before the United States Patent and Trademark Office may use the designation "Patents," "Patent Attorney," "Patent Lawyer," or "Registered Patent Attorney" or any combination of those terms, on his letterhead and office sign.

(2) A lawyer who publicly discloses fields of law in which the lawyer . . . practices or states his practice is limited to one or more fields of law shall do so by using designations and definitions authorized and approved by the [agency having jurisdiction of the subject under state law].

(3) A lawyer who is certified as a specialist in a particular field of law or law practice by [the authority having jurisdiction under state law over the subject of specialization by lawyers] may hold himself out as such, but only in accordance with the rules prescribed by that authority.

99. *Peel v. Attorney Registration & Disciplinary Comm'n*, 110 S. Ct. 2281, 2284 n.2 (1990) (quoting Brief for Academy of Certified Trial Lawyers of Minnesota as Amicus Curiae at 15).

100. These states are: Kansas, Michigan, Montana, North Dakota, Oklahoma, Rhode Island, and Wyoming. Gibbons, *supra* note 96, at 59.

101. See *supra* note 28 and accompanying text.

Analysis of earlier cases in attorney advertising provides three areas of concern which translate into the overall objectives of regulation. Regulation should seek to assist in the free flow of information to the public, to ensure that the information is not misleading, and to promote quality and competence in the legal profession. States should seek to integrate these objectives with the results of the following internal analysis in selecting the appropriate regulatory scheme.

Each state should perform an internal analysis to determine the current status of the legal profession within the state. This self-analysis should consider factors such as the population of the state relative to the number of lawyers available, the interest level of lawyers in participating in specialty certification programs, the fields of specialization to be implemented, ethical considerations, and the cost of developing and administering the program.

In states where the population is spread out, the practice of law is more general and the need for specialization and certification programs decreases. Conversely, states which have heavy concentrations of lawyers specializing in narrow practices should consider certification programs a high priority. States with considerable numbers of de facto specialists should find a high interest level in many certification programs. All states should consider the more prevalent ethical considerations: the duty to determine the degree of competence which will ensure that the public is not misled, the duty to provide the public with access to legal services, the duty to guarantee the general practitioner that specialization will not adversely affect the profession, and the duty not to create entry barriers for young and minority lawyers. Finally, the cost of administration in most programs may be offset through fees so that most plans are able to achieve self-sufficiency. Not every state is ripe for the regulation of specialization, and performing an internal analysis should provide each state with guidance in choosing the best method of regulation. Because each state will have a unique set of parameters to operate within, this Note necessarily focuses on analyzing each alternative in relation to the overall objectives of regulation.

### *B. Alternative Regulatory Schemes*

A spectrum of alternatives exists for regulating attorney advertising of certification of specialization. On one extreme is the path of least resistance: the state merely requires that the advertising be truthful and allows the free market to regulate itself. On the other extreme is a national certification program such as the "Registered Patent Attorney" designation in which the federal government certifies practitioners. In between are disclaimers, disclosures, state recognition of private certification programs, state operated certification programs, the ABA Model

Plan of Specialization, and combinations of these. Each alternative has advantages and disadvantages that should be carefully considered by each state.

Free market regulation, the least restrictive option, allows attorneys to advertise their specialty and certification as long as it is not misleading.<sup>102</sup> The seven states that do not ban specialty advertising rely on the free market forces of supply, demand, and competition to regulate specialty advertising. Lawyers, free to communicate and specialize along any parameters they may choose, provide consumers with maximum information on the availability of legal services.<sup>103</sup> Consumer demand for certain expertise encourages the development of specialties and provides efficient allocation of legal resources. Competition among lawyers encourages efficiency within the profession which arguably lowers costs to the consumer.<sup>104</sup> This scheme increases the free flow of useful information to consumers because communication is not limited to state approved specialties. Free market regulation is the most efficient means of allocating legal resources and the absence of state regulation means that the taxpayer is not burdened with the costs of program administration.

Although the absence of a ban on advertising certification and specialization increases the free flow of information at no cost to the taxpayer, it does little to protect the consumer against potentially misleading claims or to assure attorney competence. The absence of a regulating body to screen specialty and certification claims may result in consumers receiving information that is potentially misleading. Consumers are free to employ the judicial system to redress deceptive claims, but this course is pursued after the injury and results in the judicial inefficiency of case by case review. The system does not provide any measurable way to ensure professional competence other than through competition. This regulatory alternative trades off the goals of ensuring attorney competence and protecting the consumer against potentially

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102. An example of this type of scheme is found in Michigan Bar, Formal Opinion C-232 (November 1984): "A lawyer may advertise that he or she is a 'specialist' in a specific field of practice only under certain circumstances, depending on whether use of the term is misleading. . . ."

103. L. LoPUCKI, THE DE FACTO PATTERN OF LAWYER SPECIALIZATION 11-12 (1990) (suggesting that lawyers specialize along at least eight parameters: body of knowledge, type of client, side, operation, forum, geographical area, size of the matter, and relation to team).

104. See, e.g., Hazard, Pearce, & Stempel, *Why Lawyers Should Be Allowed to Advertise: A Market Analysis of Legal Services*, 58 N.Y.U. L. REV. 1084 (1983); McChesney, *Commercial Speech in the Professions: The Supreme Court's Unanswered Questions and Questionable Answers*, 134 U. PA. L. REV. 45 (1985).

misleading advertising for maximum flow of information and minimum administration costs.

The *Peel* Court suggested that disclaimers or disclosures could be used as an alternative method to regulate communication of specialty certification.<sup>105</sup> A disclaimer will inform the consumer that the certification was not by any government agency. A disclosure will also provide the consumer with the requirements for certification. Either method permits the free flow of information and attempts to prevent the presentation of misleading claims by informing the public of the nature of the certification.

The ABA modification of Rule 7.3 in response to *Shapero* illustrates a workable use of a disclaimer requiring targeted direct mail to be labeled as "Advertising Material" to inform the consumer of the nature of the letter.<sup>106</sup> The problem with disclaimers and disclosures is that an unduly burdensome requirement may do indirectly what the state cannot do directly: prohibit the communication of certification.<sup>107</sup> For example, requiring a complete list of certification requirements on a business card virtually prohibits the communication of certification by that media; therefore, states must be careful not to overburden disclaimer requirements when little guidance exists on content or length of disclosures or disclaimers.<sup>108</sup> A more pragmatic problem exists when the same disclaimer appears in every attorney advertisement.<sup>109</sup> Because the disclaimer is so common, the consumer becomes oblivious to the message and consequently it is of little or no value.

This disclaimer/disclosure alternative, like market regulation, misses the objective of assuring quality in the profession because it does not impose additional requirements or minimum standards of competence. "Any advertising scheme which does not provide for the quality concept will constantly be confronted with the problem of deceptive advertising and overreaching under the code of professional responsibility."<sup>110</sup> The disclaimer/disclosure method is, however, a minimum cost, minimum implementation program that fulfills the first amendment requirements of *Peel*. Illinois used this alternative as a band-aid response to the *Peel*

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105. *Peel v. Attorney Registration & Disciplinary Comm'n*, 110 S. Ct. 2281, 2292 (1990).

106. 83 Law Man. on Prof. Conduct (ABA/BNA) § 81:402 (1989).

107. *Zauderer v. Office of Disciplinary Counsel*, 471 U.S. 626, 651 (1985).

108. This may well be the next area the courts will be called on to address. Stewart, *The Rights of Lawyers* 76 A.B.A. J. 34, 38 (Aug. 1990).

109. A good example is the yellow page directory of Louisville, Kentucky where each attorney advertisement carries the disclaimer, "This is an advertisement. Kentucky law does not certify specialists."

110. Staton, *Access to Legal Services Through Advertising and Specialization*, 53 IND. L.J. 247, 251 (1978).

decision while continuing to study certification of specialization alternatives.

Only specialty certification programs address quality and are capable of achieving the objective of ensuring attorney competence. These certification programs come in two varieties: state approved private certification plans and state operated certification programs. Proponents of specialization urge states to adopt either plan based on the following reasons: (1) de facto specialization exists today and should be recognized; (2) the recognition of specialists will enhance legal competence in a particular field; (3) consumers will have more access to information; (4) specialization will lead to reduced costs for legal services; and (5) failure to recognize specialties implies that lawyers are competent in all fields.<sup>111</sup> Opponents are concerned that: (1) certification may adversely effect non-certified lawyers; (2) voluntary programs may become mandatory; (3) certification programs may favor large established urban firms; and (4) existing programs bear little relation to the de facto pattern of specialization in the legal profession.<sup>112</sup> Both state approved and state operated programs guarantee adherence to standardized requirements designed to provide a recognized level of expertise. The programs are voluntary and do not prohibit noncertified attorneys from practicing in specialty areas or prevent certified specialists from practicing outside their area of expertise.<sup>113</sup>

State operated certification programs directly screen attorneys in order to ensure expertise. In 1971, California initiated its certification program which requires five years in the practice of law, a percentage of time in the specialty, continuing legal education, peer review, and successful completion of a written examination.<sup>114</sup> Currently, California recognizes six areas of specialization,<sup>115</sup> and eleven states operate similar programs.<sup>116</sup> One criticism of these plans is that communication of certification is limited to state certification. Although this protects the consumer against misleading advertising, it limits the free flow of consumer information to those specialties recognized by the state. The programs do, however, promote competence in the profession by imposing initial requirements, recertification, and continuing legal education programs. Because the

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111. Comment, *Lawyer Advertising and Specialization In Montana: An Alternative Approach*, 43 MONT. L. REV. 131, 141 (1982).

112. L. LoPUCKI, *supra* note 103, at 1-2.

113. Zehnle, *supra* note 17, at 21.

114. *Id.* at 22. See also, ABA HANDBOOK, *supra* note 11, at 14.

115. These areas are: criminal law, family law, immigration and nationality law, probate estate planning and trust law, taxation law, and workers' compensation law. Status Report, *supra* note 22, at 1.

116. See *supra* note 32.

state administers the program, the costs of the program are higher than other regulatory methods. Most state certification programs, however, provide for financing through fees charged to applicants.<sup>117</sup> State operated programs prevent misleading information and assure competence at the cost of state administered programs and limited communication of specialization.

State approval of private certification programs appears to be a viable alternative in view of the Supreme Court's recognition that NBTA certification was indeed truthful advertising. Minnesota is one of the four states that has adopted a plan for approval of certifying agencies.<sup>118</sup> The plan closely approximates that of the NBTA and requires, *inter alia*, a minimum of twenty-five percent of total time devoted to the specialty in the prior three years, peer evaluation, and successful completion of an objective written or oral examination.<sup>119</sup> Screening certifying

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117. For example, California Rules of Court, Rules and Regulations of the State Bar of California Program for Certifying Legal Specialists § II(D)(1) (1991) which provides:

The fee to apply for certification and recertification shall be set by the board. Payment shall be required as a condition to the filing of the application. If the applicant for recertification chooses to take the written examination, the application fee shall be the same as the fee for certification.

118. MINN. RULES OF COURT, PLAN FOR MINNESOTA STATE BOARD OF LEGAL CERTIFICATION (1990).

119. Minnesota Rules of Court, Plan for Minnesota State Board of Legal Certification Rule 5 (1991) in its entirety reads:

5.01 The persons in a certifying agency shall include lawyers who, in the judgment of the Board, are experts in the area of the law covered by the specialty and who each have extensive practice or involvement in the specialty area.

5.02 A certifying agency's standards for certification of specialists must include, as a minimum, the standards required for certification set out in this Plan and in the rules, regulations, and standards adopted by the Board from time to time. Such standards shall not unlawfully discriminate against any lawyer properly qualified for certification as a specialist, but shall provide a reasonable basis for the determination that the lawyer possesses special competence in a particular field of law, as demonstrated by the following means:

5.021 Substantial involvement in the specialty area during the three-year period immediately preceding application to the certifying agency. "Substantial involvement" is measured by the amount of time spent practicing in the specialty area: A minimum of 25% of the practice of the lawyer must be spent in the specialty area.

5.022 Peer recommendations from attorneys or judges who are familiar with the competence of the lawyer, none of whom are related to, or engaged in legal practice with, the lawyer.

5.023 Objective evaluation of the lawyer's knowledge of the substantive and procedural law in the specialty area, to be determined by written and/or oral examination. The examination shall include a part devoted to professional responsibility and ethics as it relates to the particular specialty.

organizations ensures that certified specialists will maintain a predetermined level of competence, and by providing that only approved specialty certification may be advertised, the state protects the public from misleading certification claims. The problem with this alternative is that with the exception of the NBTA, no national specialization groups have responded to the needs of the profession for specialty certification.

The ABA Model Plan of Specialization provides a workable plan for states wishing to embark on specialization programs. This plan, once adopted, is administered by the state. Each state is free to adopt the entire plan or only applicable parts. This alternative provides more free flow of information than pure state developed and operated certification programs and serves the public in at least four ways. First, as a national organization, the ABA can respond to the need for new specialty programs more effectively and efficiently than a single state operated program. The current ABA Model Plan of Specialization recognizes twenty-four areas of specialization.<sup>120</sup> This is more than any one state currently offers, and each state is free to choose which specialty areas are appropriate. This provides consumers with a greater variety of information on available legal services by certifying and allowing more specialists to advertise. Second, state certification using the ABA model plan is verifiable by the consumer; therefore, advertising by state certified specialists will not be misleading. Third, adoption of the ABA model plan provides uniform levels of competency among the states adopting the plan. This facilitates multijurisdictional referrals by assuring that specialists have a

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5.03 The certifying agency shall be responsible for making appropriate investigations of peer recommendations and for the obtaining of any other data that may be required to assure the lawyer is in compliance with the legal certification program.

5.04 The certifying agency shall register all lawyers whom it certifies as specialists pursuant to the Plan and shall report to the Board those lawyers who are certified, maintaining, however, the confidentiality of information on applicants as required by law.

5.05 Each certifying agency shall annually submit to the Board a report of its activities during the previous year, including a demonstration of the measures employed to ensure compliance with the provisions of this rule.

5.06 The certifying agency shall cooperate at all times with the Board and perform such other duties as may be required by the Board so that the Plan is properly administered.

120. These areas are: admiralty, appellate practice, bankruptcy, business and corporate, civil rights, civil trial practice, collection, commercial, criminal, estate planning and probate, family, governmental contracts and claims, immigration, insurance, international, labor and employment, military administrative, patent, trademark and copyright, personal injury and property damage, real property, securities, taxation, workers' compensation, and franchise law. ABA STANDING COMMITTEE ON SPECIALIZATION, MODEL STANDARDS FOR SPECIALTY AREAS (1990).

uniform minimum level of competency. Finally, because the preliminary study and plan development is already completed, states avoid many administrative costs, leaving more funds in the private sector to stimulate the economy. The problem with this plan is that it does not provide for recognition or screening of private certification groups such as the NTBA. In light of *Peel*, provisions need to be incorporated to regulate rather than prohibit advertising of NBTA certification. With this exception, this alternative combines the best features of free market regulation with those of private and state certification to meet the goals of regulation: to provide consumer access to legal information, to prevent misleading advertising, ensure attorney competence, and to avoid hefty administrative costs.

National certification plans, such as the "Patent Attorney" or "Proctor in Admiralty" designations approach the extreme limits of regulation. Although every state recognizes and allows these specialties to advertise, the federal government is not likely to create more areas of specialization to keep up with consumer demand. National certification does not present a viable option in view of the *Peel* decision. The Court left each state, not the federal government, to regulate its own bar with respect to attorney advertising and certification. States must evaluate the various options for regulating attorney advertising of certification of specialization with a keen awareness of first amendment rights and the overall goals of regulation.

#### IV. CONCLUSION

Specialization, whether de facto, self-designated, or certified, is a way of life in the legal profession. Certification serves a vital societal interest by recognizing specialists and confirming that they possess the required skills for the specialty. Extending the line of attorney advertising cases favoring disclosure over concealment, *Peel* recognizes an attorney's right to specialize and communicate certification as a specialist so long as it is not misleading. To prevent misleading claims of certification, each state is free to choose the most appropriate method of regulation, but absolute prohibitions on advertising of certification violate the first amendment. Examining *Peel* and the *Bates* line of cases reveals recurring concerns that may be translated into objectives for regulation of certification advertising. The goals of regulation should be to provide the consumer with access to legal information, prevent misleading advertising, and ensure professional competence while remaining within the first amendment.

Examining the alternative regulatory schemes in relation to these objectives reveals the advantages and disadvantages of each. Free market regulation offers the greatest exchange of information and the most

efficient allocation of legal resources by permitting advertising of any specialty as long as it is not misleading. Disclaimers and disclosures provide the consumer with information on the nature of certification and thereby prevent misleading advertising. These alternatives meet the objectives of providing access to legal services, but fall short of the objective of ensuring professional competence.

Only certification plans meet all the objectives set forth for regulating advertising. States that operate certification plans regulate by screening attorneys directly while states that approve private certification groups regulate by assuring that certifying agencies adequately screen members. These plans ensure professional quality by demanding adherence to predesignated levels of competence before advertising of certification is permitted. State certification plans meet the objectives of regulation, but suffer from the disadvantage of restricting specialization advertising exclusively to state developed programs. State approval of private certification groups not only meets the objectives of regulation, but provides for advertising of NBTA certification. The problem here is that private national groups have been slow to respond to consumer demand.

The ABA Model Plan of Specialization is unequivocally the most workable plan available today. It combines the best features of free market regulation and private and state operated certification programs. As a national organization, it can develop certification programs in response to a greater number of market forces. This lessens the burden on each state to anticipate new specialty certification areas and avoids hefty development costs. It does not, however, provide for recognition of private certification groups which should be addressed either by the ABA within its plan or by each state adopting the current ABA plan. Although *Peel* does not recommend any one regulatory scheme, it compels states to make provisions other than an outright ban to allow communication of specialty certification. Given the expansive trend in attorney advertising and the Court's recognition of certification programs, states would be well advised to begin planning for the use of certification programs in their regulatory schemes.

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## APPENDIX

AMERICAN BAR ASSOCIATION  
MODEL PLAN OF SPECIALIZATION

The following Model Plan of Specialization was proposed by the ABA Standing Committee on Specialization and was adopted by the House of Delegates on August 15, 1979.

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**1. Purpose**

The purpose of this Plan of Specialization ("Plan") is to assist in the delivery of legal services to the public by:

- 1.1 Providing greater access by the public to appropriate legal services;
- 1.2 Identifying and improving the quality and competence of legal services; and
- 1.3 Providing appropriate legal services at reasonable cost.

**2. Establishment of Board of Legal Specialization**

The Supreme Court hereby establishes a Board of Legal Specialization ("Board"), which Board shall be the authority having jurisdiction under state law over the subject of specialization of lawyers. The Board shall be composed of nine members appointed by the Supreme Court. One of the members of the Board shall be the chairperson of the Advisory Commission (described in Section 7) and all other members of the Board shall be lawyers licensed and currently in good standing to practice law in this state. The lawyer members of the Board shall be representative of the legal profession and shall include lawyers who are in general practice as well as those who specialize. One of the lawyer members shall be designated annually by the Supreme Court as chairperson of the Board. The lawyer members of the Board shall hold office for three years, except those initially appointed who shall serve as hereinafter designated. The lawyer members shall be appointed by the Supreme Court to staggered terms of office and the initial appointees shall serve as follows: two shall serve for one year after appointment; three shall serve two years after appointment; and three shall serve for three years after appointment. Appointment to a vacancy among the lawyer members shall be made by the Supreme Court for the remaining term of that lawyer member leaving the Board. Any lawyer member shall be eligible for reappointment to not more than one additional three-year term after having served one full three-year term.

Meetings of the Board shall be held at regular intervals, at such times and places and upon such notice as the Board may from time to time prescribe.

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### 3. Powers and Duties of the Board

The Board shall have general jurisdiction of all matters pertaining to regulation of specialization and recognition of specialists in the practice of law and shall have the power and duty:

- 3.1 To administer the Plan;
- 3.2 To designate specialties of law practice and define the scope and limits of such specialties and to provide procedures for the achievement of these purposes;
- 3.3 To appoint, supervise, act on the recommendations of and consult with Specialty Committees as hereinafter identified;
- 3.4 To consult with the Advisory Commission as hereinafter identified;
- 3.5 To make and publish standards for the recognition of specialists, upon the Board's own initiative or upon consideration of recommendations made by the Specialty Committees, such standards to be designed to produce a uniform level of competence among the various specialties in accordance with the nature of the specialties;
- 3.6 To recognize specialists or deny, suspend or revoke the recognition of specialists upon the Board's own initiative, upon recommendations made by the Specialty Committees or upon requests for review of recommendations made by the Specialty Committees;
- 3.7 To establish and publish procedures, rules, regulations and bylaws to implement this Plan;
- 3.8 To propose, and request the Supreme Court to make, amendments to this Plan whenever appropriate;
- 3.9 To cooperate with other boards or agencies in enforcing standards of professional conduct and to report apparent violations of the Code of Professional Responsibility of this state to the appropriate disciplinary authority;
- 3.10 To evaluate and approve, or disapprove, any and all continuing legal education courses, or educational alternatives for the purpose of meeting the continuing legal education requirements established by the Board for the recognition of specialists and in connection therewith to determine the specialties for which credit shall be given and the number of hours of credit to be given in cooperation with the authority having jurisdiction over continuing legal education; to determine whether and what credit is to be allowed for educational alternatives, including other methods of legal education, teaching, writing and the like; to issue rules and regulations for obtaining approval of continuing legal education courses and educational alternatives; to publish or cooperate with others in publishing current lists of approved continuing legal education courses and educational alternatives; and to encourage and assist law schools, the authority having jurisdiction over continuing legal education, local bar associations and other groups engaged in continuing legal education to offer and maintain programs of continuing legal education designed to develop, enhance and maintain the skill and competence of legal specialists; and
- 3.11 To cooperate with other organizations, boards and agencies engaged in the recognition of legal specialists or concerned with the topic of legal specialization.

#### 4. Retained Jurisdiction of the Supreme Court

The Supreme Court retains jurisdiction with respect to the following matters:

- 4.1 Amending this Plan;
- 4.2 Hearing appeals taken from actions of the Board; and
- 4.3 Establishing or approving fees to be charged in connection with this Plan.

#### 5. Privileges Conferred and Limitations Imposed

The Board in the implementation of this Plan shall not alter the following privileges and responsibilities of recognized specialists and other lawyers:

5.1 No standard shall be approved which shall in any way limit the right of a recognized specialist to practice in all fields of law. Any lawyer, alone or in association with any other lawyer, shall have the right to practice in all fields of law, even though he or she is recognized as a specialist in a particular field of law;

5.2 No lawyer shall be required to be recognized as a specialist in order to practice in the field of law covered by that specialty. Any lawyer, alone or in association with any other lawyer, shall have the right to practice in any field of law; even though he or she is not recognized as a specialist in that field;

5.3 All requirements for and all benefits to be derived from recognition as a specialist are individual and may not be fulfilled by nor attributed to the law firm of which the specialist may be a member;

5.4 Participation in the program shall be on a completely voluntary basis;

5.5 A lawyer may be recognized as a specialist in more than one field of law. The limitation on the number of specialties in which a lawyer may be recognized as a specialist shall be determined only by such practical limits as are imposed by the requirement of substantial involvement and such other standards as may be established by the Board as a prerequisite to recognition as a specialist;

5.6 When a client is referred by another lawyer to a lawyer who is a recognized specialist under this Plan on a matter within the specialist's field of law, such specialist shall not take advantage of the referral to enlarge the scope of his or her representation and, consonant with any requirements of the Code of Professional Responsibility of this state, such specialist shall not enlarge the scope of representation of a referred client outside the area of the specialty field; and

5.7 Any lawyer recognized as a specialist under this Plan shall be entitled to advertise that he or she is a "Board Recognized Specialist" in his or her specialty to the extent permitted by the Code of Professional Responsibility of this state.

## 6. Specialty Committees

The Board shall establish a separate Specialty Committee for each specialty in which specialists are to be recognized. The Specialty Committee shall be composed of seven members appointed by the Board, one of whom shall be designated annually by the Board as chairperson of the Specialty Committee. Members of the Specialty Committee shall be lawyers licensed and currently in good standing to practice law in this state who, in the judgment of the Board, are competent in the field of law to be covered by the specialty. Members shall hold office for three years, except those members initially appointed who shall serve as hereinafter designated. Members shall be appointed by the Board to staggered terms of office and the initial appointees shall serve as follows: two shall serve for one year after appointment; two shall serve for two years after appointment; and three shall serve for three years after appointment. Appointment by the Board to a vacancy shall be for the remaining term of the member leaving the Specialty Committee. All members shall be eligible for reappointment to not more than one additional three-year term after having served one full three-year term. Meetings of the Specialty Committee shall be held at regular intervals, at such times and places and upon such notice as the Specialty Committee may from time to time prescribe or upon direction of the Board.

Each Specialty Committee shall advise and assist the Board in carrying out the Board's objectives and in the implementation and regulation of this Plan in that specialty. Each Specialty Committee shall advise and make recommendations to the Board as to standards for the specialty and the recognition of individual specialists in that specialty. Each Specialty Committee shall be charged with actively administering the Plan in its specialty and, with respect to that specialty, shall:

6.1 After public hearing on due notice, recommend to the Board reasonable and nondiscriminatory standards applicable to that specialty;

6.2 Make recommendations to the Board for recognition, continued recognition, denial, suspension or revocation of recognition of specialists and for procedures with respect thereto;

6.3 Administer procedures established by the Board for applications for recognition and continued recognition as a specialist and for denial, suspension or revocation of such recognition;

6.4 Administer examinations and other testing procedures, if applicable, investigate references of applicants and, if deemed advisable, seek additional information regarding applicants for recognition or continued recognition as specialists;

6.5 Make recommendations to the Board concerning the approval of and credit to be allowed for continuing legal education courses, or educational alternatives, in the specialty; and

6.6 Perform such other duties and make such other recommendations as may be requested of or delegated to the Specialty Committee by the Board.

## 7. Advisory Commission

The Supreme Court shall appoint an Advisory Commission composed of five nonlawyers, one of whom shall be designated annually by the Supreme Court as chairperson of the Advisory Commission. The Advisory Commission shall assist and advise the Board as to the public's legal needs and assist the Board in determining how the public can best be served through the specialization program. The members of the Advisory Commission shall hold office for three years, except those members initially appointed who shall serve as hereinafter designated. Members shall be appointed by the Supreme Court to staggered terms of office as follows: one shall serve for one year after appointment; two shall serve for two years after appointment; and two shall serve for three years after appointment. Appointment to a vacancy shall be made by the Supreme Court for the remaining term of the member leaving the Advisory Commission. Any member shall be eligible for reappointment to not more than one additional three-year term after having served one full three-year term. Meetings of the Advisory Commission shall be held at regular intervals at such times and places and upon such notice as the Advisory Commission shall prescribe or upon direction of the Board. Members of the Advisory Commission shall have the right to attend all meetings of the Board and the chairperson of the Advisory Commission shall be a voting member of the Board.

## 8. Minimum Standards for Recognition of Specialists

To qualify for recognition as a specialist, a lawyer applicant must pay any required fee, must demonstrate to the Board with respect to the specialty knowledge of the law of this state and competence and must comply with the following minimum standards:

8.1 The applicant must be licensed and currently in good standing to practice law in this state;

8.2 The applicant must make a satisfactory showing, as determined by the Board after advice from the appropriate Specialty Committee, of substantial involvement in the specialty during the three years immediately preceding his or her application according to objective and verifiable standards. Such substantial involvement shall be defined as to each specialty from a consideration of its nature, complexity and differences from other fields and from consideration of the kind and extent of effort and experience necessary to demonstrate competence in that specialty. It is a measurement of actual experience within the particular specialty according to any of several standards. It may be measured by the time spent on legal work within the area of the specialty, the number or type of matters handled within a certain period of time or any combination of these or other appropriate factors. However, within each specialty, experience requirements should be measured by objective standards. In no event should they be either so restrictive as to unduly limit recognition of lawyers as specialists or so lax as to make the requirement of substantial involvement meaningless as a criterion of competence.

Substantial involvement may vary from specialty to specialty, but, if measured on a time-spent basis, in no event shall the time spent in practice in the specialty be less than twenty-five percent (25%) of the total practice of a lawyer engaged in a normal full-time practice. Reasonable and uniform practice equivalents may be established including, but not limited to, teaching, judicial, government or corporate legal experience;

8.3 The applicant must make a satisfactory showing, as determined by the Board after advice from the appropriate Specialty Committee, of continuing legal education accredited by the Board for the specialty, the minimum being an average of ten hours of credit for continuing legal education, or its equivalent, for each of the three years immediately preceding application. Upon establishment of a new specialty, this standard may be satisfied in such manner as the Board, upon advice from the appropriate Specialty Committee, may prescribe or may be waived if, and to the extent, suitable continuing legal education courses have not been available during the three years immediately preceding establishment of the specialty; and

8.4 The applicant must make a satisfactory showing, as determined by the Board after advice from the appropriate Specialty Committee, of qualification in the specialty through peer review by providing, as references, the names of at least five lawyers, all of whom are licensed and currently in good standing to practice law in this state, or judges, who are familiar with the competence and qualification of the applicant as a specialist. None of the references may be persons related to the applicant or, at the time of application, a partner of or otherwise associated with the applicant in the practice of law. The applicant by his or her application consents to confidential inquiry by the Board, or appropriate Specialty Committee, of all such references, the appropriate disciplinary body and other persons regarding the applicant's competence and qualification to be recognized as a specialist.

## 9. Minimum Standards for Continued Recognition of Specialists

The period of recognition as a specialist shall be five years. During such period the Board or appropriate Specialty Committee may require evidence from the specialist of his or her continued qualifications for recognition as a specialist and the specialist must consent to inquiry by the Board, or appropriate Specialty Committee, of lawyers and judges, the appropriate disciplinary body or others in the community regarding the specialist's continued competence and qualification to be recognized as a specialist. Application for and approval of continued recognition as a specialist shall be required prior to the end of each five-year period. To qualify for continued recognition as a specialist, a lawyer applicant must pay any required fee, must demonstrate to the Board with respect to the specialty both continued knowledge of the law of this state and continued competence and must comply with the following minimum standards:

9.1 The specialist must make a satisfactory showing, as determined by the Board after advice from the appropriate Specialty Committee, of substantial involvement (which shall be determined in accordance with the principles set forth in Section 8.2) in the specialty during the entire period of recognition as a specialist;

9.2 The specialist must make a satisfactory showing, as determined by the Board after advice from the appropriate Specialty Committee, of continuing legal education accredited by the Board for the specialty during the period of recognition as a specialist, the minimum being an average of ten hours of credit for continuing legal education, or its equivalent, for each year during the entire period of recognition as a specialist; and

9.3 The specialist must comply with the requirements set forth in Sections 8.1 and 8.4, above.

## 10. Establishment of Additional Standards

The Specialty Committee for each specialty may recommend, and the Board may establish, additional or more stringent standards, including, but not limited to, oral or written examinations, or a combination of such examinations. If examination is required, it must be applied uniformly to all applicants; provided, however, that waiver of the requirement may be permitted if additional and substantially more stringent standards are required of those for whom waiver is permitted. The Specialty Committee may also recommend, and the Board may establish, requirements which further define or quantify with at least equal stringency the minimum standards set forth herein for recognition or continued recognition as a specialist. Additional standards or requirements established under this section need not be the same for initial recognition and continued recognition as a specialist.

## 11. Suspension or Revocation of Recognition as a Specialist

The Board may revoke its recognition of a lawyer as a specialist if the specialization program in the specialty is terminated or may suspend or revoke such recognition if it is determined, upon the Board's own initiative or upon recommendation of the appropriate Specialty Committee and after hearing before the Board on appropriate notice, that:

11.1 The recognition of the lawyer as a specialist was made contrary to the rules and regulations of the Board;

11.2 The lawyer recognized as a specialist made a false representation, omission or misstatement of material fact to the Board or appropriate Specialty Committee;

11.3 The lawyer recognized as a specialist has failed to abide by all rules and regulations promulgated by the Board;

11.4 The lawyer recognized as a specialist has failed to pay the fees required;

11.5 The lawyer recognized as a specialist no longer meets the standards established by the Board for the recognition of specialists; or

11.6 The lawyer recognized as a specialist has been disciplined, disbarred or suspended from practice by the Supreme Court or any other state or federal court or agency.

The lawyer recognized as a specialist has a duty to inform the Board promptly of any fact or circumstance described in Sections 11.1 through 11.6, above.

If the Board revokes its recognition of a lawyer as a specialist, the lawyer cannot again be recognized as a specialist unless he or she so qualifies upon application made as if for initial recognition as a specialist and upon such other conditions as the Board may prescribe. If the Board suspends recognition of a lawyer as a specialist, such recognition cannot be reinstated except upon the lawyer's application therefore and compliance with such conditions and requirements as the Board may prescribe.

## 12. Right of Hearing and Appeal to Supreme Court

A lawyer who is denied recognition or continued recognition as a specialist or whose recognition is suspended or revoked shall have the right to a hearing before the Board and, thereafter, the right to appeal the ruling made thereon by the Board to the Supreme Court under such rules and regulations as the Board and the Supreme Court may prescribe.

## 13. Financing the Plan

The financing of the Plan shall be derived solely from applicants and participants in the Plan. If fees are not established by the Supreme Court, the Board shall establish reasonable fees in each specialty field in such amounts as may be necessary to defray the expense of administering the Plan, which fees may be adjusted from time to time. If established or adjusted by the Board, however, the fees must be approved by the Supreme Court as provided in Section 4.3, above.



STATEMENT OF OWNERSHIP, MANAGEMENT AND CIRCULATION <small>Required by 39 U.S.C. 3685</small>					
1A. Title of Publication		1B. PUBLICATION NO.			2. Date of Filing
Indiana Law Review		0	0	9	04198 9/30/91
3. Frequency of Issue		3A. No. of Issues Published Annually			3B. Annual Subscription Price
Quarterly		4			\$25.00
4. Complete Mailing Address of Known Office of Publication (Street, City, County, State and ZIP+4 Code) (Not printers)					
735 W. New York Street, Indianapolis, Marion County, Indiana 46202					
5. Complete Mailing Address of the Headquarters of General Business Offices of the Publisher (Not printer)					
735 W. New York Street, Indianapolis, Marion County, Indiana 46202					
6. Full Names and Complete Mailing Address of Publisher, Editor, and Managing Editor (This item MUST NOT be blank)					
Publisher (Name and Complete Mailing Address) Indiana University School of Law-Indianapolis 735 W. New York Street, Indianapolis, Marion County, Indiana 46202					
Editor (Name and Complete Mailing Address) Rolanda Haycox 735 W. New York Street, Indianapolis, Marion County, Indiana 46202					
Managing Editor (Name and Complete Mailing Address) John Payton 735 W. New York Street, Indianapolis, Marion County, Indiana 46202					
7. Owner (If owned by a corporation, its name and address must be stated and also immediately thereunder the names and addresses of stockholders owning or holding 1 percent or more of total amount of stock. If not owned by a corporation, the names and addresses of the individual owners must be given. If owned by a partnership or other unincorporated firm, its name and address, as well as that of each individual must be given. If the publication is published by a nonprofit organization, its name and address must be stated.) (Item must be completed.)					
Full Name		Complete Mailing Address			
Trustees of Indiana University		Bloomington, Indiana 47401			
8. Known Bondholders, Mortgagees, and Other Security Holders Owning or Holding 1 Percent or More of Total Amount of Bonds, Mortgages or Other Securities (If there are none, so state)					
Full Name		Complete Mailing Address			
None		None			
9. For Completion by Nonprofit Organizations Authorized To Mail at Special Rates (DMM Section 423.12 only) The purpose, function, and nonprofit status of this organization and the exempt status for Federal income tax purposes (Check one)					
(1) <input checked="" type="checkbox"/> Has Not Changed During Preceding 12 Months		(2) <input type="checkbox"/> Has Changed During Preceding 12 Months		(If changed, publisher must submit explanation of change with this statement.)	
10. Extent and Nature of Circulation <small>(See instructions on reverse side)</small>		Average No. Copies Each Issue During Preceding 12 Months		Actual No. Copies of Single Issue Published Nearest to Filing Date	
A. Total No. Copies (Net Press Run)		1593		2200 9/3/91	
B. Paid and/or Requested Circulation 1. Sales through dealers and carriers, street vendors and counter sales		10		0	
2. Mail Subscription (Paid and/or requested)		973		1967	
C. Total Paid and/or Requested Circulation (Sum of 10B1 and 10B2)		983		1967	
D. Free Distribution by Mail, Carrier or Other Means Samples, Complimentary, and Other Free Copies		110		110	
E. Total Distribution (Sum of C and D)		1093		2077	
F. Copies Not Distributed 1. Office use, left over, unaccounted, spoiled after printing		500		123	
2. Return from News Agents		0		0	
G. TOTAL (Sum of E F1 and 2--should equal net press run shown in A)		1593		2200	
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